OUR ECONOMIC SYSTEM

VOLUME II

BY

H. GORDON HAYES

PROFESSOR OF ECONOMICS IN THE
OHIO STATE UNIVERSITY

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CHAPTER XXXII

BUSINESS CYCLES

In the preceding chapter attention was directed to the subject of price fluctuations. Such fluctuations are only part of the general fluctuation to which modern business is subject. Particularly, so far as the state of prosperity of the various lines of business is concerned, there is marked variation from time to time. Countless illustrations could be given of this. The following chart shows the variation in the output of mineral products for a period of eight years. This is a composite series of the items,

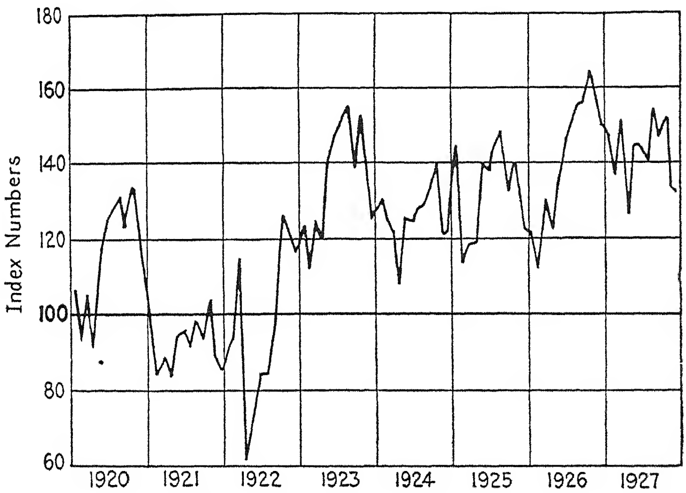

CHART I. Index of Mineral Production, 1920–1927. (Average monthly production 1919 = 100, but no index numbers computed for individual months of 1919. Data from *Survey of Current Business.*)

anthracite coal, bituminous coal, petroleum, iron ore, copper, zinc, lead, and silver, each appropriately weighted. The curve is constructed somewhat after the manner of an index number

of prices. The chart clearly indicates marked variations in the production of mineral from one season to another, and also from one year to another. Some charts are "corrected for seasonal variation" and also for "secular trend" — a process which will be explained presently — but this curve is not so corrected.

Chart II shows a similar curve of manufactured items, showing the variation in the quantity of manufactured goods produced during that period.

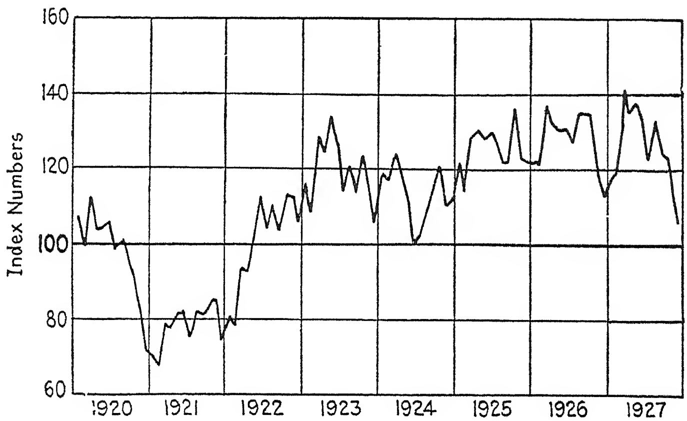

Chart II. Index of Manufacturing Production, 1920–1927. (Average monthly production 1919 = 100, but no index numbers computed for individual months of 1919. Data from *Survey of Current Business.*)

A curve of almost any single item of production or type of economic service would show similar, though not equal, fluctuation from time to time. Building construction, cigar manufacture, automobile production, freight movement on railroads, sales of retail department stores, and of mail order houses, to mention a few cases, all show variation in output over any appreciable period of time. The rate of interest for commercial paper, the price of bonds, and the volume of bank checks are likewise subject to change. All business is in flux: all lines wax and wane.

Seasonal Variation. — Some of the variations in business are markedly seasonal. The following chart, number III, shows the variation over a period of nine years for, first, the sales in 5 and

10 cent stores, and second, the volume of production of Portland cement.

It is evident from a glance at these two curves that the items plotted are subject to marked seasonal variation. From two to

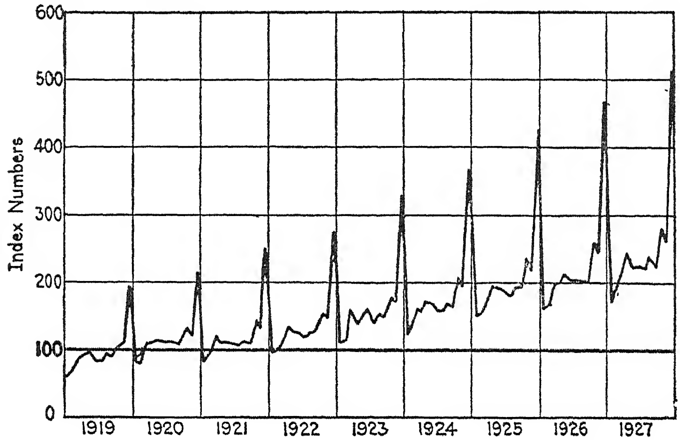

CHART IIIa. Index of sales of 5 and 10 cent stores (5 chains), 1919–1927. (Average monthly sales 1919 = 100. Data from Federal Reserve Board.)

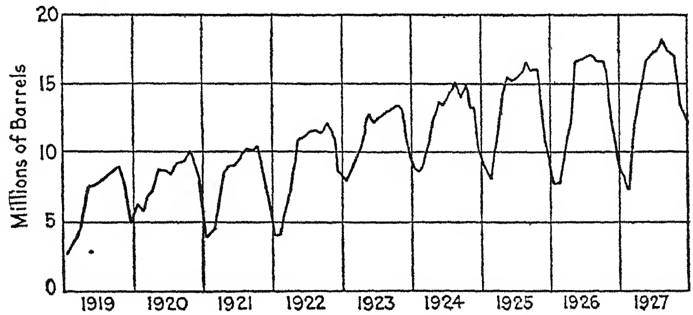

CHART IIIb. Production of Portland Cement, 1919–1927. (Data from *Survey of Current Business.*)

three times as much goods are sold in the 5 and 10 cent stores in December as in January, according to this curve. The seasonal variation of Portland cement is not so marked as this, but the monthly production in August for almost every one of these years was over twice the monthly production in the preceding January and February.

Not all production, however, shows regular variation according to the seasons of the year. This is true, for example, of pig iron, as indicated in Chart IV.

The production of pig iron is clearly subject to variation, but the seasonal variation is not the dominant one. The curve for

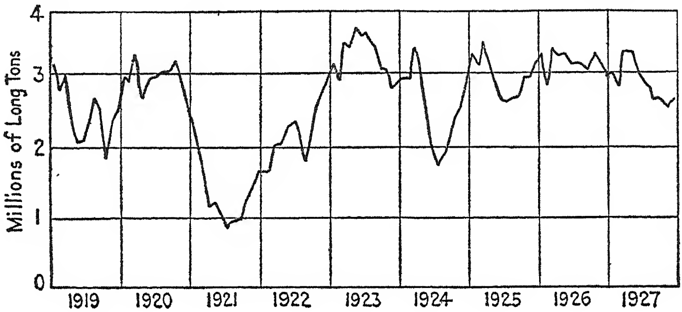

Chart IV a. Production of Pig Iron, 1919–1927. (Data from *Survey of Current Business.*)

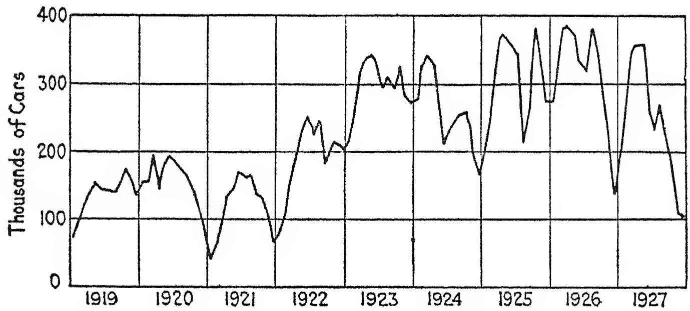

Chart IV b. Production of Passenger Cars, 1919–1927. (Data from National Automobile Chamber of Commerce.)

automobile production, also shown in Chart IV, shows considerable variation during these five years, but the seasonal variation, while present, is not regular in its movements. In each case there is some seasonal variation, but it is neither marked nor regular.

Secular Trend. — In a growing country such as the United States, most lines of industry show an expansion in business over a period of years. This is clearly shown in all the curves in the above charts. The average output of cement in 1927 according

to these data was 100 per cent above the output for 1919, and larger than the output for any of the other years for which data are given. The output of automobiles in 1927 was almost twice the output of 1919. Changes of this kind are described as secular. In each of these lines of business the secular trend was upward during these years. Occasionally the secular trend may be downward as in the case of a good that is being replaced by another. Horse-drawn carriages experienced a downward secular trend as that form of transportation was giving way to the automobile.

Correction for Seasonal Variation and Secular Trend. — In discussing the problem of the ups and downs of business, it is very desirable in many cases to eliminate the purely seasonal and secular changes, and thus see more clearly the movements due to the cyclical factor. Do the sales in the 5 and 10 cent stores in December, 1925, for example, as shown in Chart III, indicate a good, poor, or fair condition in that line? This could not be determined by comparing the December sales with those for July. Even a very considerable increase for December over July might mean poor business. Business could not be said to be good unless the December sales correspond favorably with those for other December months. Further, in such a comparison allowance would have to be made for the normal growth of the business.

Statisticians have given a great deal of attention to this problem, and have sought to plot curves of business movements from which the seasonal variation and the secular trend are removed. For an analysis of the different forms of technique used, the reader is referred to the books of statisticians.[1] Only the general principle that is involved will be given here. This may be indicated by referring to the curve of the output of cement, in Chart III above. For this curve the trend is approximately a straight line. By computation, a figure can be found which will indicate the yearly increase in output — or the increment of secular trend. If this is, let us say, 1,500,000 barrels per year, then other than the usual output would be indicated for any

[1] See especially W. C. Mitchell, *Business Cycles*, 1927, Chapter III.

one year, only if the production for that year exceeded the production of the previous year by either more or less than 1,500,000 barrels. An increase of just this amount would be merely secular. Similarly, if the average output during the summer is found to be 100 per cent higher than the output during the winter, then an unusual condition will appear only in case the summer production exceeds that of the winter by more or less than 100 per cent. Such a degree of seasonal variation and such a change in yearly output could be considered to be normal. If the production year by year corresponded to this condition, such a state of affairs could be indicated on a chart by a straight line, which would be the base line. Fluctuations above or below this base line could then be indicated. The effects of the seasonal and secular movements having been eliminated, such a chart would show only the cyclical fluctuations and certain other minor residual movements generally referred to as "accidental."

Chart V shows curves of volume of manufacture and mining as adjusted for seasonal variation and secular trend by the Harvard Economic Society.

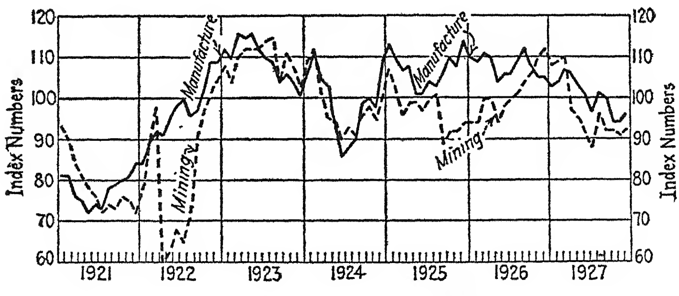

CHART V. Volume of Manufacture and Mining, 1921–1927. Corrected for seasonal movements and for secular trend. (From Harvard Economic Society Weekly Letter of January 28, 1928.)

This chart shows the fluctuations from normal in the volume of manufacturing and mining in the United States. These curves, it must be emphasized, do not show the original data; they have been corrected to allow for the usual seasonal movements and for secular trend. The fact that the adjusted curves show higher points in August, 1927, for example, than for July,

1927, does not indicate that either more or less manufactured goods and minerals were produced in the former month than in the latter. It merely indicates that in relation to the normal course of manufacturing and mining in the United States the volume of output was greater in August than in July.

In terms of the ups and downs of business the curves indicate a higher degree of prosperity for 1923 than for 1924; and better conditions during 1925 than during 1924, but yet not equal to those which prevailed in 1923. Conditions in 1926 in manufacturing appear to have approximated those for 1925. A decline from normal in both lines began in the latter months of 1926 and continued throughout 1927.

Lack of Uniformity in Fluctuations in Different Lines. — Emphasis thus far has been laid on the fact of variation in the volume of business activity in the different lines of enterprise.

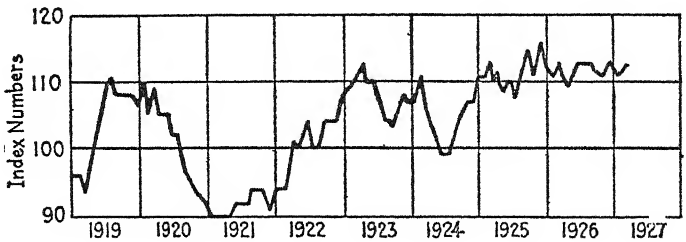

CHART VI. Snyder's *Index of Volume of Trade,* January, 1919–March, 1927. (Data from Snyder, *Business Cycles and Business Measurements,* p. 310, and Research Department, Federal Reserve Bank of New York.)

The question now arises as to how closely the fluctuations in the individual lines synchronize. That is, do all lines of business fluctuate together? Do good times and bad times prevail uniformly throughout industry? Or do they fluctuate sufficiently closely that the various fluctuations can be represented as a single curve which will indicate the state of prosperity? Most economists have talked as if these questions could be answered in the affirmative, and many business statisticians have drawn curves to indicate the general state of prosperity. Carl Snyder, statistician of the Federal Reserve Bank of New York, has re-

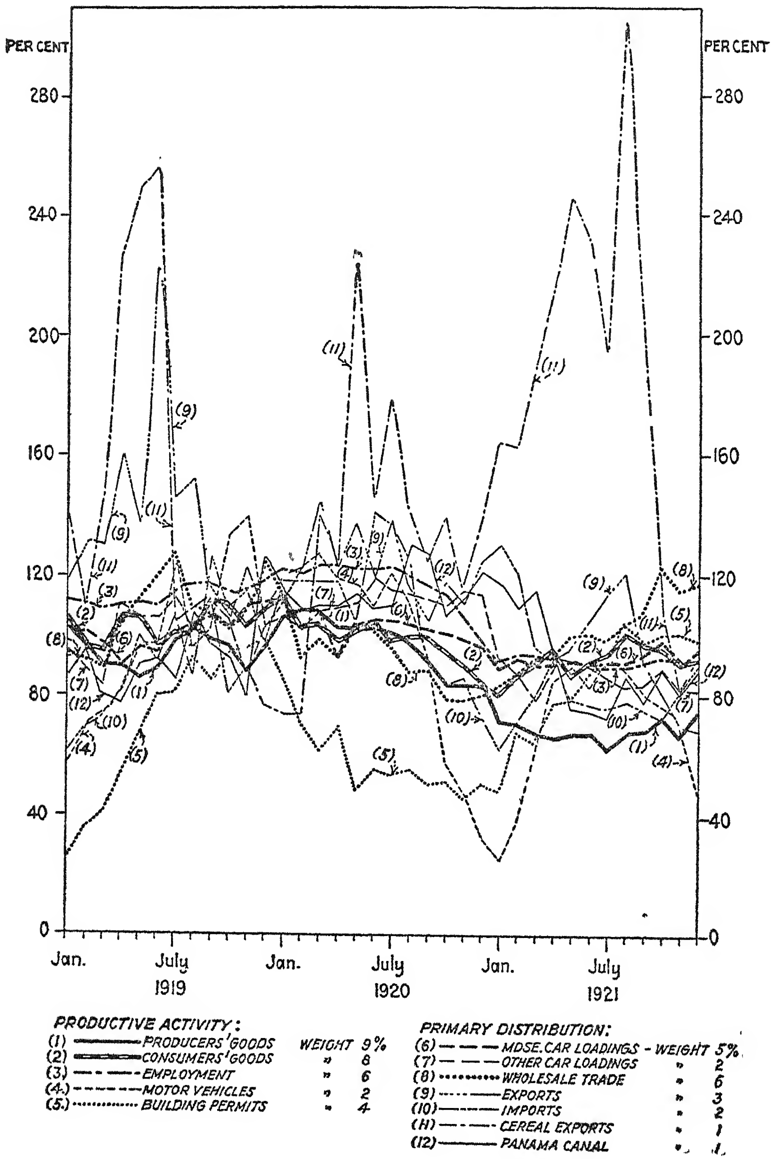

CHART VII a. Twelve of the 28 Components Used in Snyder's Volume-of-Trade Index to Represent *Productive Activity* and *Primary Distribution*. (From Mitchell, *ibid.*, Chart 18, pp. 310–311.)

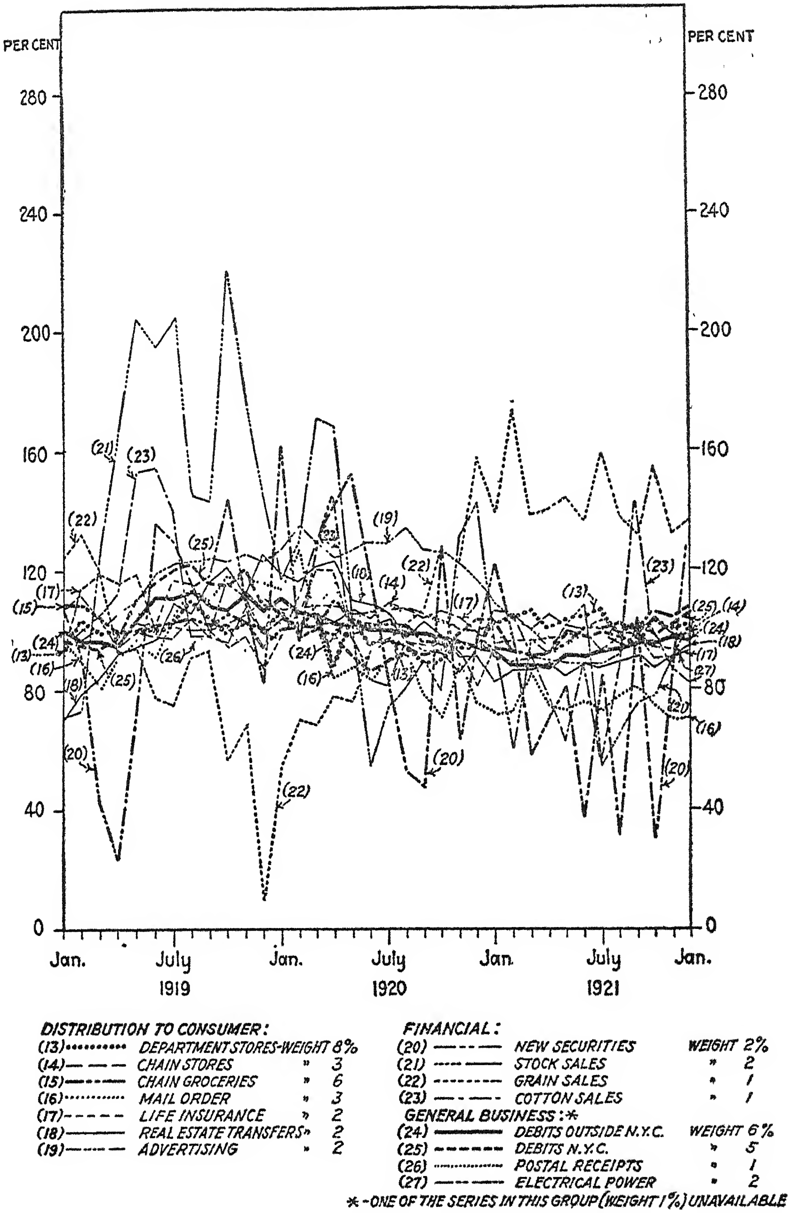

Chart VIIb. Fifteen of the 28 Components Used in Snyder's Volume-of-Trade Index to Represent *Distribution to Consumers, Finance*, and *General Business*. (*Ibid.*)

cently made such a curve which he calls the *Volume of Trade.* This is Chart VI on page 9.

Many similar curves of "general business conditions" could be given as just suggested. No person who has compiled such a curve would claim for a moment that it represents more than a general approximation to the actual situation. But the question can be raised as to whether even this is claiming too much for it — whether it indicates the general condition of business for the time covered. Wesley Clair Mitchell, an eminent authority on this subject, in his recent excellent book, *Business Cycles,* doubts the validity of such a curve as a representation of cyclical movements in business. He gives Chart VII, pages 10 and 11, which shows 27 of the 28 series from which Snyder constructed the volume-of-trade index, and says regarding this that anyone who dwells on the intricacies of this chart, "made in this way, will grant not only that the business indexes fail to picture business cycles, but also that faithful pictures would be of doubtful value." [1]

In further support of this general contention, Mitchell compares the curves of general business of several different experts and finds much variation among them as to the state of business at different dates.[2] Later in his discussion he says, "It is difficult to construct from the data, or even to conceive of constructing, any single index of the general trend in business activity." [3]

As Snyder's twenty-seven time series, in Chart VII, show, all forms of business activity do not fluctuate together. When times are bad in some lines, they are good, or even exceptionally good, in other lines. This is strikingly shown in Chart VIII, which gives the variation in output in a long list of industries for two six-month periods.

Industries connected with the petroleum industry and with the building industry show marked increases for the period under consideration, but almost without exception the other industries show a recession in activity. Clearly all lines of business,

[1] P. 309. [2] See Chapters II and III, pp. 307–360. [3] P. 454.

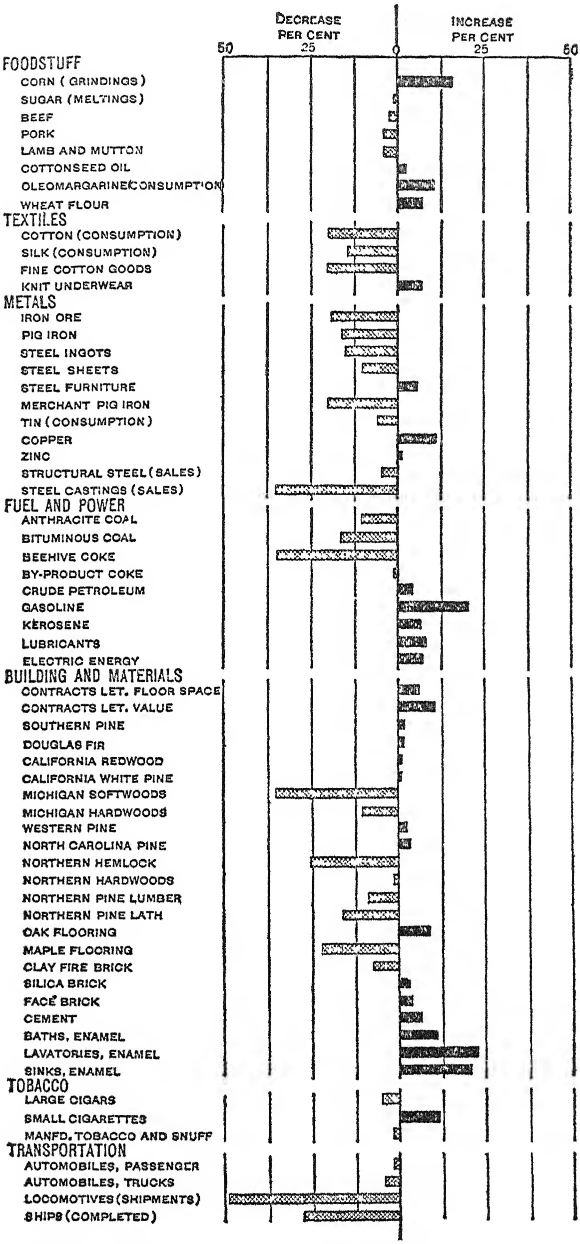

CHART VIII.[1] Production of Specified Commodities in the First Half of 1924. (Percentage increase or decrease from corresponding period of 1923.)

[1] From the *Survey of Current Business*, August, 1924, p. 6, as given in *Forecasting Business Conditions*, 1927, by C. O. Hardy and G. V. Cox, p. 10.

if this chart is at all accurate, do not fluctuate together. But granting that there is not a high degree of uniformity in the fluctuation in prosperity in the different lines of business, is it sufficiently close that we can, first, properly say that business is good or bad, or fair? Second, is the relationship so close and are the fluctuations so regular that good and bad times can be said to be cyclical? And, third, is the relationship so regular and periodic that it is proper to speak of *a* business cycle, or of *the* business cycle?

Unquestionably, economists have long talked of *a* business cycle — of *the* business cycle. Recently, however, doubts have been expressed as to the validity of this concept. Professor Irving Fisher, for example, has recently attacked the validity of the entire cyclical concept in business. There are merely haphazard changes, he argues, such as are found in the weather or luck at Monte Carlo.

> ". . . the cycle idea is supposed to have more content than mere variability. It implies a regular succession of *similar* fluctuations, constituting some sort of *recurrence*, so that, as in the case of the phases of the moon, the tides of the sea, wave motion, or pendulum swing, we can forecast the future on the basis of a pattern worked out from past experience, and which we have reason to think will be copied in the future. We certainly cannot do that in predicting the weather, or Monte Carlo luck." [1]

And he adds that neither can this be done in relation to business.

This view of the matter is undoubtedly not warranted. Certain prominent lines of economical activity do fluctuate sufficiently closely that the terms *good times* and *bad times* are valid as general expressions of the state of prosperity for business as a whole. To quote from Mitchell again:

> "Even when economic time series are reduced to percentage deviations from their secular trends adjusted for seasonal variations, the fluctuations in some cases still seem as irregular as the fluctuations of the weather, or of 'Monte Carlo luck.' But there are many series of which this cannot be said. When charted, the fluctuations of pig-iron production, unemployment percentages, bank clearings, and building

[1] Irving Fisher, "Our Unstable Dollar and the So-called Business Cycle," *Journal of the American Statistical Association*, June, 1925, vol. XX, p. 192. Quoted in Mitchell, *ibid.*, p. 466.

permits, to cite but a few examples, prove to be decidedly less irregular than the fluctuations of a weather chart, a chart of net gold shipments, or of potato crops. In no case are the fluctuations highly regular; but in many cases they are far from haphazard, despite the inability of statisticians to free what they call 'cyclical' changes from what they call 'irregular' perturbations. Further, the cyclical-irregular fluctuations of the series which individually show semblance of regularity are found to have tolerably regular relations with one another in respect to time, duration, and amplitude of movement — relations many of which have been suggested by economic theory. Finally, in timing and direction these inter-correlated fluctuations agree closely with the evidence given by business annals concerning a long-continued and wide-spread recurrence of prosperity, recession, depression and revival." [1]

Lack of Periodicity. — But although the fluctuations in many lines of business have a somewhat high degree of regularity they do not have a high degree of periodicity. Many observers have set definite time limits to the cyclical movements: they have sought to press the fluctuations into one time mold. The National Bureau of Economic Research has recently completed an extensive study of the records of the state of business as they are found in newspapers, journals, and documents.[2] On the basis of these findings, Mitchell concludes that from the close of the Civil War to the end of 1923 there were fifteen business cycles in the United States. One of these ran from 1873 to 1882, a period of nine years. Three were five years in length, three were four years, five were three years, and three had a duration of two years, according to his findings. From similar data for other countries he finds that in all of them there has been marked variation in the duration of the business cycles.[3]

Interestingly enough, the various writers who have set definite average time limits to the periods of good and bad business differ greatly from each other. The periods given range all the way from 3½ years to 11 years, and in one case to 33 years. The fact of these differences, and also the commonly observed experience that some business men say business is good when

[1] P. 466. [2] *Business Annals*, by W. L. Thorp.
[3] *Ibid.*, Chapter IV, Sec. IV.

others say it is bad, suggests the need for great caution in setting any time limit for any period of good or bad business. Particularly, the conclusion seems to be warranted that there is nothing in the way of a regular period of time between one period of prosperity and another.

Lines Most Subject to Change. — Although the state of prosperity in the different lines of business is not altered simultaneously, there is sufficient similarity from time to time that the business conditions may properly be said to be good or bad. There are some lines of enterprise that are particularly susceptible to change, and within these lines the large scale firms have great variability as compared with small scale firms. This is indicated by the conditions which prevailed following the severe break in prices in 1920, which marked the culmination in the post-war business boom. One significant test of the state of prosperity is the volume of employment, and barring unusual shifts in demand or changes in the technique of production, the employment figures for any single line of enterprise may be taken as an indication of the state of prosperity therein. The following table shows the decline in employment in various groups of industries from the peak of 1920 to the depression of 1921–1922. It will be noted that the volume of employment in factories, steam railways, and mining was reduced by some 30 per cent during this time. In contrast to this, the volume of employment in the group of activities listed in the lower part of the table suffered a loss of employment of less than 5 per cent.

The table is also significant in calling attention to the great difference between large scale and small scale industry in relation to the effect of the depression upon the volume of employment. While the employment in all the factories employing 20 or less employees decreased by less than 9 per cent, the employment in the establishments of more than 100 employees was reduced by almost 40 per cent.

This table indicates that the fields of manufacture, mining, transportation, and building and construction are particularly susceptible to variation in prosperity. This is what one should expect to find. These lines of industry are particularly de-

TABLE 1 [1]

CYCLICAL DECLINE IN THE VOLUME OF EMPLOYMENT OFFERED BY DIFFERENT INDUSTRIES, AND BY ESTABLISHMENTS OF DIFFERENT SIZES, FROM THE PEAK OF PROSPERITY IN 1920 TO THE TROUGH OF DEPRESSION IN 1921–1922

	All Establishments Per Cent Decline	*Establishments with 0–20 Employees Per Cent Decline*	*Establishments with 21–100 Employees Per Cent Decline*	*Establishments with over 100 Employees Per Cent Decline*
All Industries	16 50	3 08	13.84	28.23
All Factories	29 97	8 21	19.21	38 56
Steam Railways	29 68	*a*	*a*	29 68
Extraction of Minerals	29.66	*a*	*a*	30.18
Building and Construction	18.92	14.66	*a*	*a*
Finance	7.14	0 00	0.00	25.58
Transportation other than Railways	6.77	3.72	9.80	8.17
Wholesale Trade	5.64	0.00	12 31	7.77
Public and Professional Service	4.57	*a*	*a*	*a*
Domestic and Personal Service	4.11	5.40	4.48	3.92
Agriculture	3.18	2.15	*a*	*a*
Retail Trade	2.75	1.31	4.66	10.84
Hand Trades other than Building	0.00	2.11	4.67	*a*

a Reports received from less than 20 enterprises.

The comparisons are based upon quarterly reports from 9,289 enterprises, and cover the full years 1920 and 1921, and the first three months of 1922.

Adapted from Willford I. King, *Employment, Hours and Earnings in Prosperity and Depression. United States, 1920–1922.* National Bureau of Economic Research, New York, 2d. ed., 1923, pp. 55–58, 60. (I have corrected a misprint in the source.)

pendent on most of the other lines of business, and manufacture, mining, and transportation are highly dependent on each other. The demand of consumers for goods, of manufacturers for coal

[1] Taken together with footnotes from Mitchell, *ibid.*, p. 88.

and for minerals for use as raw materials, and of manufacturers and raw material producers for transportation services are very closely related.

Appreciably more than one-half of the total number of wage earners in the United States are employed in these lines of industry that have just been noted, and over three-fourths of these are found in concerns that employ one hundred or more persons. Thus a very large portion of the wage-earning population of the United States are in lines of work that are peculiarly susceptible to cyclical fluctuations in the volume of business. The very fact that bad times in business may thus affect so many workers tends to aggravate the situation. The unemployment that occurs because of unfavorable business in some one line of industry tends to reduce the demand of laborers for consumption products and also reduces the demand of the business men in the lines affected for raw materials and equipment. This in turn may lead to further discharge of employees and thus still further increase the amount of unemployment, or in other words, contribute to making the state of business much less satisfactory than it otherwise would be.

Business That Is But Little Affected. — In order to see the situation as it is, it is desirable to look at the other side of the picture so far as the regularity of business and of employment is concerned. It follows from the above discussion that approximately one-half of the wage earners of the country are engaged in industries that are but little exposed to the hazards of business cycles. These lines of work are indicated in the middle and lower part of the above table. Another phrasing for this is that the positions of employment for about one-half of the wage workers of the country are relatively free from fluctuations in the volume of business activity. Further, it is to be noted that according to the census of occupations for 1920, ten million persons are working on their own account. This is about one-fourth of the total number of persons that are gainfully employed in the United States. Perhaps nine-tenths of this number are in industries least affected by the cyclical fluctuations in business.[1]

[1] Mitchell, *ibid.*, p. 89–90.

Combining these data it appears that well over one-half of the persons in the United States who are gainfully employed are in lines of work that are but little exposed to the hazards of business fluctuation. And of course out of the large numbers that are employed in manufacturing, mining, transportation, building and construction, but relatively few of these are subject to unemployment as a result of the decreases in prosperity which occur occasionally. It is only after a severe break in business prosperity such as occurred in 1920 that the proportion of unemployed in these lines is large. This helps to an understanding of the fact that during the usual depressions in business activity the economic life of the nation, considered as a whole, goes on very much as before, and that even in a period of marked depression such as 1921–1922, the totality of the economic activity of the nation goes on much the same as during a period of prosperity.

Four Stages. — In discussing the course of the cyclical movements, most writers distinguish four stages; namely, prosperity, decline, depression, and recovery. Prosperity comes again next in order, and so on around the cycle again. Some writers divide some of these stages and thus get more than four stages in the complete cycle. Taking the four stages as the best working description of the matter, it must be noted that there is no special validity in beginning the description with the stage of prosperity. One might as well begin with any of the others. It must be further noted that one of these stages is as "normal" as is any of the others. To put this differently, a period of depression is no more abnormal in our modern industrial system than is a period of prosperity. The different stages run their ceaseless round. These stages, however, are often not clearly marked and, further, the change in the total volume of the economic activity of the nation may differ but little as business runs the course of these different stages in the state of prosperity. This is another way of repeating the point which was emphasized above, that it is only in certain lines of activity that there are pronounced cyclical fluctuations.

Causes of Cyclical Fluctuations. — It has been frequently stressed in the preceding chapters of this book that our economic

society is one of great complexity — that there is a very high degree of economic interdependence among the persons and the business firms that make up the society — and that readjustments are forever being made among the various lines of economic activity that are being carried on. It is in this situation that the causes for periods of good and bad times are found. Prosperity prevails when all lines of enterprise are well coördinated with each other — when the countless wheels of the system are in mesh. At such a time there is but little, if any, unemployment. A business depression prevails at a time when the various parts of the system are not well coördinated — when the products in many lines, at least, cannot be sold to persons engaged in other lines of enterprise. Unemployment of laborers and idleness of equipment are, obviously, characteristics of such a condition.

A search for the causes of depressions is hence a search for the reasons why the various parts of the system get out of balance — why coördination in some periods gives way to lack of coördination, and the explanation of a return to prosperity after a depression is an answer to the question as to how coördination is reëstablished after it has been disturbed.

A great deal of thought has been given to this problem during the past one hundred years, and innumerable books and articles have been written on the subject by some of the keenest men of each generation in the many countries where the modern economic system is found. The explanations of these scholars have been most diverse, and even now after all of these years of study and investigation the controversy among the able specialists still waxes hot. Mitchell's book, so often referred to in the preceding pages of this chapter, gives an excellent summary of the different theories,[1] and a recent book by Hansen [2] is devoted to an analysis of these various explanations. Mitchell lists twenty-six different explanations which he classifies into three divisions. Many of these are closely similar, but each differs from the others in some respects. Only brief attention can be given here to these business-cycle theories.

[1] In Chapter I. [2] A. H. Hansen, *Business-Cycle Theory*, 1927.

W. Stanley Jevons, an eminent English economist, developed the thesis (during the 1870's) that business cycles are caused by the changes in the heat intensity of the sun. His argument was that spots on the sun result in a variation in the heat which is generated and thus that the development of crops is affected and hence that the purchasing power of farmers is reduced. This in turn reduces the purchasing power of the farming population and hence results in a reduction in the volume of sales by manufacturers. Thus according to him, variation from time to time in the heat of the sun affects the entire gamut of industrial life. It was then believed that the sun spot cycle was something more than ten years in duration. Jevons' conclusion from his investigation of business activity was that the cycle which he found there corresponded exactly with that of the sun spots.

Recently Professor Moore of Columbia University has developed a somewhat similar theory. His thesis is that there is a regular cycle of rainfall which leads to variations in crop production and thus affects the general economic life. Moore's cycle periods run for thirty-three years and within these he finds cycles of eight years. He explains the rainfall cycle by the fact that every eight years the planet Venus is in relatively close proximity to the earth. Moore's theory is not an attempt at a complete explanation of business cycles, but merely an effort to focus attention upon one cause of the variations in agricultural production, which is but one factor in determining economic conditions as a whole. Other theories of weather causation have been advanced. One is to the effect that weather influences the general state of health and in that way influences economic activity. Needless to say, the analysis in regard to the lack of regular periodicity in business cycles suggests that dependence upon regularly timed cycles outside of business cannot be well founded.

Another line of explanation that has been advanced is that people are subject to cyclical fluctuations of optimism and pessimism, and that as a result of this there are periods of activity followed by periods of depression. Several writers have found the basis for business cycles in the innovations and inventions

which are made from time to time in our industrial processes. These new methods, it is argued, disturb the existing arrangements and thus lead to a lack of coördination among the various branches of industry. Still others have insisted that the difficulty lies in the fact that persons are constrained to save so much money that there is not sufficient buying power left to take from the markets the goods which are offered for sale. As a result of this, it is claimed that manufacturers find themselves unable to dispose of their products and thus a period of price cutting and unemployment and lack of production sets in. A somewhat similar explanation is that the arrangements of the economic system do not permit enough money to flow to consumers to enable them to buy the goods that are produced at the prices which sellers must get if they are to make a profit. That is, it is argued that even if consumers did not wish to save, they would not have enough money to buy the products of the producers.

A great deal has been written in defense of the theory of oversaving. Many careful students see considerable grounds for this idea. They stress the fact that the productive capacity of a country, such as the United States, seems to be ever on the point of outrunning the consumptive capacity. As has been suggested in earlier pages, there are but few lines of industry in the United States in which the industrial equipment is not sufficient to turn out a much larger volume of goods than is now being produced. This tends to indicate that the manufacturers of the country are at least always tending to approach the point of producing more than they can sell at the prevailing prices.

Another very significant feature of our modern economic system which bears upon this point is that the pressure to sell on the part of sellers is invariably stronger than is the inclination to buy on the part of buyers. The sellers are the ones who advertise and who in devious ways entreat the buyers to make purchases. They are the ones who are unfailingly gracious to the prospective customer and deeply thankful to him when the sale has been consummated. Situations arise occasionally in which the importunities come from the buyers rather than from the

sellers. But, to repeat, in our present system the buyers as a group do not quickly take from the market the goods which are available. Shelves of retail merchants and warehouses of wholesale dealers and of manufacturers are usually well stocked, and prospective customers are eagerly sought at the expense of large sums of money and of great effort. When this condition becomes pronounced, as in 1920, prices are cut, manufacturing is curtailed, and unemployment and idleness of equipment ensue.

This is another way of saying that as producers, we seem to have capacity to produce more than we wish to use as consumers. Economists have long emphasized the insatiability of human wants. The argument has been that people are always anxious to extend the scale of consumption. Within certain groups this is perhaps true, but an observation of the spending habits of many sections of the population suggests that expenditures are very largely conventional and that spending habits do not change rapidly. Thus many persons do not quickly convert the buying power which comes into their possession into consumption goods. They save goodly portions of it. The savings, broadly speaking, take the form of new industrial equipment which in turn will still further augment the volume of consumption goods which are available. Hence sellers may be unable to sell because of the amount of savings which have been made.

This interesting phenomenon of the pressure of sellers upon prospective buyers lies at the heart of the whole problem of cyclical fluctuations in business. All of the many explanations of business cycles are fundamentally devoted to an explanation of this situation. As just suggested, the oversaving doctrine is one explanation that is offered. Similarly, the point that consumers cannot under a system of private enterprise receive enough in the form of wages and other incomes to permit them to buy the goods that are offered, is an attempt to account for this situation.

Still another explanation which has not yet been mentioned bears pointedly upon this fact of our modern economic system. This is that production comes to be misdirected. According to

this explanation, the fault is not that too much money is saved, nor that consumers do not have enough money with which to buy the products of industry, but that in the complicated process of carrying on production through the instrumentality of thousands of different enterprises, it comes about that some of the goods produced are not the ones that consumers wish to purchase. Thus according to this argument, lack of coördination results because of the inability of entrepreneurs to gauge properly the wishes of consumers.

This last mentioned explanation unquestionably is very reasonable. In our highly complex and interdependent economic system, with the many thousands of separate and independent entrepreneurs carrying on production for a common market, it is certainly only to be expected that many mistakes will be made. In any one industry over a period of time it is highly probable that so many men might be attracted to undertake that work and so much equipment constructed to carry it on, that eventually so much would be produced that it would be impossible to find purchasers for it at a price which would return to the producers the amount which they had invested. Such a situation would tend to cause prices to be cut in that line and production to be curtailed. The situation may be still further complicated by having many of the business men concerned forced into bankruptcy. Such failures in one line, as already indicated, would tend to react disastrously upon other lines of industry.

In his summary of the various business cycle theories, Mitchell reaches the conclusion that perhaps all of them contain an element of truth. His position is thus that there is no one single explanation of this phenomenon of recurring periods of depression. It may be added in conclusion that whatever the explanation of the phenomenon may be, this fact of recurring periods of bad times is a very serious defect of the present economic system. With thousands, if not millions, of persons undersupplied with economic goods, it is a sad commentary upon our economic arrangements that our productive capacity is so often not fully utilized in serving these unsatisfied wants.

Banking Mechanism. — During the past century, periods of bad business in the United States were often greatly aggravated because of accompanying money or banking panics, as already indicated in the chapters dealing with money and banking in the preceding volume. These panics resulted from the demands on the part of business men, who because of failure to sell their goods came to be sorely in need of money with which to meet their obligations. When demands on the part of business men came to be of any considerable volume, the banking system was unable to supply their needs. This then led to desperate attempts to raise money which would usually take the form of sacrifice sales of commercial securities. This would lead to violent falls in the prices of such securities and this in turn tended to affect disastrously the general credit situation throughout the country. But, as was indicated in the description of the Federal Reserve System, our present banking mechanism is such that we are perhaps in no danger of having money panics such as formerly prevailed. The provisions for elasticity in deposits and in Federal Reserve notes are perhaps sufficient to prevent financial distress in any situation that may conceivably arise. Indeed the severe test which was given to the new banking system when prices collapsed in 1920, indicates that it is well qualified to weather the storms of bad business.

It must also be noted in this connection that many persons believe that the banking system can be used to keep the price level uniform, and it is argued that this will largely remove the business cycles. This point, it will be recalled, was discussed in the closing chapter of the preceding volume of this book. The desirability of thus exercising control over the money system, of which the banking system is the major part, cannot well be questioned. If the price level can be controlled some of the extreme fluctuations in the state of prosperity of the country can be prevented. The booms that accompany rising prices, and the depressions that follow a period of sharply rising prices would then be eliminated. Minor fluctuations would undoubtedly continue.

The control that is now being exercised through the Federal

Reserve Board is, as indicated in the preceding chapter, another illustration of the evolution of social processes — of the tendency of men to lay the physical and the social forces under tribute. More specifically, the control over the price level indicates an additional stage in the evolution of money.

Business Forecasting. — During the past few decades increasing attention has been given to the subject of business forecasting, as was suggested in a previous chapter.[1] There are now in the United States several agencies which are devoted to the problem of forecasting the coming conditions of business activity. This work is carried on by private firms that furnish their services for a consideration to business men, and also by bureaus of business research in several different universities. All of these agencies are engaged in an attempt to make it possible for business men to make more accurate judgments than they would otherwise make in regard to the conduct of their enterprises. This involves, obviously, the question of the volume of production to be undertaken in the various lines of activity.

Criticisms are offered from time to time in regard to the soundness of many of the forecasts that are made. The factors involved, as is implied in the fact that there are so many different explanations of business cycles, are very complex and the causal relationships are very difficult to understand. But despite the shortcomings of a great deal of forecasting, the very fact that so much attention is given to it is very wholesome. It tends not only to lead to a fuller understanding of cyclical fluctuations, but it also brings sharply to the attention of business men the fact that business runs through alternate periods of prosperity and depression. This tends to make men cautious in regard to their commitments, and as a result it would seem impossible that the lack of coördination would not be less because of the attention given to the problem of forecasting. The whole matter of forecasting, it may be observed, is based on the assumption that much, if not all, of the difficulty in regard to business cycles comes from a lack of proper direction of activity on the part of entrepreneurs.

[1] Chapter XX.

Employment Exchanges. — If periods of hard times cannot be prevented because of the complexity of the economic system, there are at least several things that may be done to mitigate them. For one thing, employment agencies may be maintained to facilitate the reëmployment of persons who have been thrown out of work. As suggested above, the lack of unemployment on the part of any considerable group of the population tends to reduce the demand for consumption goods, and thus tends to lead to further unemployment and hence to an accentuation of a period of bad times. Thus it is highly important from the point of view of the system as a whole, to secure the reëmployment of discharged workmen just as soon as it is possible to do so. Further, of course, such reëmployment is a matter of very serious import to the persons who are themselves affected. It would seem to be highly desirable for any modern industrial system to maintain at public expense a series of employment agencies. These, further, should be well coördinated so that the demands for laborers in various parts of the country can be correlated with the supply of persons who are seeking employment. During the World War such a series of agencies was established under the supervision of the United States Government. Unfortunately, however, the system was abandoned shortly following the close of the war.

Unemployment Insurance. — Another device that would tend to shorten the periods of unemployment — the periods of hard times — is unemployment insurance. Such insurance has been provided on a large scale in England and very recently in Germany. The German system is by far the most extensive system of that kind that has yet been introduced. It went into effect on the 1st of October, 1927. Under this scheme all manual workers are included, and as well all non-manual workers with annual incomes under $1,500. The only exception is that agricultural workers who are able to support themselves from the land that they occupy are not included. The system in England does not include domestic servants nor persons engaged in agriculture.

The workers in Germany, as well as in England, are called

upon to contribute part of their weekly wages to a fund which will be drawn upon in case of unemployment. It is estimated that the contributory savings under this scheme will amount to three million dollars per week when employment is good. This will, during even a relatively short period of time, lead to the accumulation of a very large fund which can be drawn upon during a period of unemployment. When unemployment occurs, the distribution of a portion of this fund will almost necessarily result in an improvement in business as compared with the situation that would otherwise prevail. The unemployment payments will be considerably less than the wages that would have been received if employment had continued, but instead of there being a complete lack of buying power on the part of the unemployed, their ability to spend will be in part continued.[1]

Public Works. — Another practice that is often recommended is that the various governments should plan to construct their buildings and other public works during periods of poor business rather than during periods of prosperity. There are, obviously, limits beyond which such a program could not be carried. Some construction cannot wait upon the most favorable time for it to be undertaken. But to some extent this can be done. Many writers have urged that when large numbers of men are unemployed, the government should furnish employment in the way of the construction of public works, even if such projects are but little needed. What may appear to be wasteful construction may, it is argued, be socially advisable during such a time. If men are unemployed, and if they would not otherwise be employed then clearly any service which they can perform means that society does not lose entirely the labor service that would otherwise be wasted because of non-utilization. Further, such employment, by increasing the buying power of consumers, would tend to shorten the period of depression.

Liberal Wages. — It is frequently urged that one way to prevent the coming of hard times is for manufacturers to pay

[1] Felix Morley, *New Republic,* Nov. 30, 1927, Vol. 53, p. 42.

liberal wages. This argument is in line with some of the business-cycle theories noted above, which are to the effect that the trouble arises because of a lack of buying power on the part of the general public. There are obvious limits beyond which such a program could not be carried, but clearly spending power is a necessary element in the maintenance of coördination among the various parts of the economic system. If it is true that productive power does tend to outrun buying power, then wage advances would tend to delay the time at which goods could not be sold.

This point is also applicable to periods of depression. When prices are falling, manufacturers may insist that wages should be reduced in order that their costs may be brought down to the prices at which they have to sell. But such cuts in wages will aggravate the situation, as buying power will be further reduced, and prices may have to be cut below the point at which the movement might otherwise have been checked. Wage cuts at such a time may thus prolong a period of depression to the disadvantage of business men, as well as of wage earners. Any one manufacturer tends to benefit by a cut in the wages which he has to pay, but he tends to suffer as a result of the wage cuts that other manufacturers make, for the market for his products is thereby reduced.

PROBLEMS AND EXERCISES

1. Talk to three or four business men and find from them whether they believe business is good or bad. Inquire also whether they regard business as better or worse than a year ago. What is their view in regard to the trend during the next year?

2. Select some one line of business not mentioned in the text and tell why you should expect the state of prosperity therein to vary from time to time.

3. (*a*) Compare Chart IIIa and IVb in regard to trend, seasonal, and cyclical movements.

(*b*) Sketch what you think would be the appearance of Chart IVb if it were adjusted for trend and seasonal movements.

4. "This curve has been corrected for seasonal variation. It indicates that the output of pig iron in October exceeded the output for July." Can both of these sentences be true? Discuss.

5. "The method of constructing Chart VI is somewhat similar to the method of constructing an index number." Explain.

6. What is Fisher's argument to prove that there are no business cycles? What rebuttal can be offered?

7. What are the significant things shown in table 1?

8. "One of the stages of business prosperity is as normal as another." Explain.

9. Account in a general way for the fact that so many different explanations have been given of the cause of business cycles.

10. Discuss the significance of the unemployment scheme in Germany.

REFERENCES

The best book in this field is Mitchell's *Business Cycles: The Problem and Its Setting*, 1927, which has been drawn upon heavily for the material of this chapter. A. H. Hansen, *Business-Cycle Theory*, 1927, gives a good analysis of the various explanations of business cycles. W. T. Foster and W. Catchings have published several books emphasizing the inability of consumers to buy the output of industry at a profit to producers: *Money*, 1923; *Profits*, 1923; and *Business Without a Buyer*, 1927. These authors have also published several magazine articles dealing with this subject. *Forecasting Business Conditions*, 1927, by C. O. Hardy and G. V. Cox, is one of the best books on this aspect of the subject of business cycles. The subject is also discussed in the books that are listed in the appendix, and also from time to time in the economic journals, and in many of the magazines.

CHAPTER XXXIII

FOREIGN EXCHANGE

Transference of Money Claims. — The extension of economic relations across national boundary lines makes necessary the transfer of money claims from one country to another. These economic relations are, of course, essentially the same as those that obtain within any area where commerce has been developed. They involve buying and selling goods, loaning and borrowing money, rendering and receiving services of many kinds, and transfers in the form of gifts. In the case of such transactions between persons in different countries it becomes necessary, if the two countries have different monetary units, for the person who makes the payment or collects the amount due to "change" the money of one country into the money of the other. That is, to "change" American dollars into English pounds, for example, or pounds into dollars. Hence, the expression *foreign exchange*.

Foreign exchange is thus a term of narrow meaning. It does not mean the exchange of goods and services between persons of different nations, as one might expect, but merely the exchange of the money of one nation for the money of another nation. In the early development of international economic relations this took the form of the exchange by travelers, who were often traders, of money of their countries for money of the country that they were entering. Certain persons finally came to specialize in the making of such exchanges and were known as money changers, or money dealers. Such money changing is still done to some degree by foreign travelers, but the principal "exchange" operations to-day are between the banks of the different countries. Usually such banks are in the leading commercial centers, such as New York, London, Paris, Berlin or Tokio.

Foreign Exchange Operations. — The mechanism of foreign exchange will first be described on the assumption that the gold standard prevails in the countries under consideration. The illustrations will be taken from the exchange relations between the United States and England. Suppose that an American exporter in New York sells a cargo of wheat to a dealer in London with the understanding that payment is to be made in London. This means that the American exporter must take steps to collect the amount due for the wheat. He will accordingly write out a statement of his claim on the English buyer in the customary form; or as this is usually stated, he will draw a bill of exchange — a commercial draft — on the English purchaser. This will order the English buyer to pay to the American seller, or to a bank for him, the sum involved in the transaction, which in this case will be stated in English money, pounds sterling. The American exporter will sell this bill to a bank, and will thus exchange the pounds to which he has claim in London for dollars in New York.

In some cases the bank would take the bill for collection rather than buy it, but for simplicity in analysis, a purchase will be assumed. The New York bank will then send the bill of exchange, or commercial draft, to the bank in London which is its correspondent. The London bank will credit the account of the New York bank with the present worth of the bill and will collect the amount specified from the English purchaser of the wheat. The New York bank will then have a deposit account, a balance, in the London bank, or will have augmented the account that it had already established. It will own pounds in London.

What is the American bank to do with such a balance in the London bank? For one thing it may use it as a basis for interest earnings, receiving interest payment from the English bank on the amount of the deposit. But for the most part, American banks build up such bank credit in England — buy English money from American traders and others who may have it to sell — in order that they may resell it at a profit. The transaction is essentially that of a merchant.

To whom may an American bank expect to sell the pounds which it holds in an English bank? Principally to American importers. An American importer, for example, buys a bill of goods from an English dealer and promises to pay him in London. In order to make the payment he must transfer pounds, or the right to pounds, to his English creditor. Accordingly, he goes to an American bank and asks to buy a bill of exchange on London, that is, he asks to buy pounds in London. The banker sells him a draft, a bill of exchange, on a London bank in which it has an account. In other words, the American bank trades some of its pounds in London to the American importer for dollars in New York. The importer then mails the bank draft — the bill of exchange — to the merchant in London from whom the goods were purchased. The merchant presents it at the bank on which it is drawn, or at another bank which later presents it at that bank, and the amount specified is paid to the merchant and deducted from the account of the American bank.

Transactions That Involve Exchange. — American exportation of goods to England thus results in Americans owning pounds in England, which they normally wish to sell — to exchange — for American dollars; and American importation of goods from England gives rise to a demand by Americans for pounds in England, that is, to offers by Americans to buy pounds, to exchange dollars for pounds. In short, exportation from America *increases the supply* of pounds in England for sale by Americans, and importation from England *increases the demand* of Americans for pounds in England.

Similarly, any transaction between Americans and Englishmen that will necessitate payment by Americans will lead to a demand upon New York banks for pounds in London with which payment may be made; and any transaction that will necessitate payment by Englishmen will mean that Americans will have claims to pounds in London which they will wish to sell to New York banks. Thus the following transactions all call for the purchase in New York of bank drafts (bills of exchange) on English banks: the purchase of goods by Americans from

Englishmen, the shipping of goods by American traders in English boats, the carrying of insurance in English companies, the paying of interest on money borrowed in England, the loaning of money to Englishmen (buying English bonds), the sending of money by the United States Government to officials in England, or by persons in this country to relatives or friends in England, and traveling in England by Americans. These all call for the purchase in American banks of drafts that can be cashed in England: they all increase the demand in New York for pounds in London.

The counterpart of each of the above transactions results in certain Americans having claims upon Englishmen to pounds in London. These claims are then sold to New York banks, or to other banks in this country. The banks are then able to resell these pounds to American traders and others who wish to use pounds in England.

It should perhaps be noted that the transactions which have been referred to are commonly classified into *visible* and *invisible* imports and exports. Goods are called *visible* imports or exports as the case may be, and the other transfers are called *invisible* exchanges.

The above phrasing is oversimplified because it assumes that in transactions between Englishmen and Americans payments are always made in London in terms of pounds. This is not always true. Some of the settlements are made in New York in terms of dollars, and some by payment with drafts on banks in other countries. But the description as given is largely true, and the difficulty that is usually experienced in understanding the fundamentals of foreign exchange makes it advisable for the student to assume at first that all settlements between Americans and Englishmen are made in London in terms of English currency.

The Rate of Exchange. — The price at which the banks of one country buy and sell money claims on the banks of another country is called the rate of exchange. The rate, or price, at which American banks in New York buy and sell English pounds in London, to continue the discussion in terms of

American-English exchange, fluctuates around \$4.86 2/3. This is due to two conditions. First, the English pound contains 113 grains of pure gold and the American dollar 23.22 grains, and thus one gold pound is equivalent to approximately 4.86 2/3 gold dollars. Second, any difference between the amount owed to New York banks by London banks, and the amount owed to London banks by New York banks must be paid in gold. The paper money of one country does not normally pass current in the other country. Gold is the universal medium of exchange. The gold that is used in international payments, it may be noted parenthetically, is seldom in the form of coins, but is in the form of what is called gold bars. When the rate of exchange between New York and London is \$4.86 2/3 exchange is said to be at par.

The Gold Points. — But although an English gold pound in New York, or its equivalent in gold bars, is equal in gold content to \$4.86 2/3, and American dollars in London, or their equivalent in gold bars, are equal to pounds in the proportion of 4.86 2/3 to 1, the rate of exchange is seldom exactly at this point. The primary reason for this is that in the exchange transactions, the dollars are in New York and the pounds are in London, and to ship gold across the Atlantic Ocean involves the expense of freight charges, insurance, and interest on the gold while it is in transit. Clearly, then, a bank in New York might give in New York more than the gold dollar equivalent of a pound in order to have pounds at its disposal in London, or it might be willing to take in New York less than the dollar equivalent of pounds that it possesses in London. That is, the New York banks will pay more than par for pounds rather than incur the expense of shipping gold to London, and will sell pounds for less than par in order to avoid the expense of shipping gold from London to New York. But if the Atlantic Ocean were no wider than the Hudson River this would not be the case: the rate of exchange would then not normally vary from par.

It follows from this that the expense of shipping gold across the Atlantic Ocean marks the limits of the fluctuation of the

rate of exchange from par. A bank will not sell in New York the pounds which it has in London at less than their dollar equivalent per pound, \$4.86 2/3, minus the cost of shipping 113 grains of gold from London to New York. The expense of such shipment varies from time to time, but is usually somewhere between two and three cents per 113 grains. The lowest price, then, at which a New York bank would sell the pounds which it possesses in London would be, approximately, \$4.84. Rather than sell at a lower figure, the bank would prefer to have the gold equivalent of its pounds shipped to New York at its expense. Hence, \$4.84, approximately, may be called the *low gold point*, or, for New York banks, the gold import point.

Similarly, a New York bank would not pay for pounds in London a higher price than \$4.86 2/3, plus the expense of shipping gold from New York to London. Rather than pay more than this, it would be profitable for the bank to exchange its cash for gold in New York and ship the gold to a bank in London for credit as pounds. Hence, \$4.89, approximately, is the *upper gold point*, or to New York banks, the gold export point.

Further, since New York banks can afford to export gold when they can sell exchange for \$4.89, and import it when they can buy exchange for \$4.84, or at approximately these figures, it is impossible that the price of exchange on London should normally rise above the one point or fall below the other. Competition among banks will prevent any one bank from charging its customers more than the one sum, or from buying bills from its customers at a price below the other. The *gold points* thus mark the limits of the fluctuation of the rate of English exchange in New York, when, as this analysis assumes, the money system of each of the two countries is on a gold basis.

The fluctuation of the rate of exchange within the limits of the gold shipment points depends upon the general supply and demand conditions in foreign exchange. If New York banks possess a plentiful supply of pounds in London — if they have large balances in London banks — and if the demand in New York for pounds in London is relatively light, the rate of exchange will decline. It will move toward the lower gold point,

the gold import point. This movement will be the more marked as New York banks anticipate that they may have to import gold. On the other hand, of course, if the demand in New York for pounds in London is heavy relatively to the supply of pounds held in London by New York banks, the rate of exchange will rise. And as New York banks anticipate that it may be necessary for them to ship gold to London in order to build up their balances there and be able to continue to perform the merchant function of selling exchange on London, the rate charged will rise to the gold export point.

Sources of Supply and Demand. — The sources of supply and demand in the exchange market have already been indicated but may be noted again. They are found in the operations that give rise to claims by persons in one country upon persons in the other country. Some of the transactions mean that payments must be made by Englishmen to Americans and thus they increase the supply of claims on Englishmen; the others mean that Americans are due to make payment in England, and thus they increase the demand for drafts payable in England.

There is another important element in the situation which may temporarily affect the exchange market, namely, the rate of interest. The money which a bank has on deposit in a foreign bank, if sufficient in amount, may be the basis for interest earnings. Thus if the rate of interest is high in London relatively to the rate in New York, New York banks will be more anxious than otherwise to maintain balances in London. Accordingly, they will increase their bids for English pounds, and will be less desirous than formerly of selling pounds, and as a result the rate of exchange will rise.

On the other hand, a lowering of the rate of interest in London relatively to the rate in New York will set in operation an opposite train of forces and the rate of exchange will fall.

The rate of interest also affects the rate of exchange in another way. If the rate of interest (discount) is raised in London this will mean that time bills — bills payable in, say, 30, 60, or 90 days — will command a lower cash price than formerly,

since the present worth of a sum payable in the future becomes less as the rate of discount rises. Hence, banks in New York that have purchased such bills will be less anxious to sell them to London banks than they otherwise would be: they will be more desirous of holding them until they are due. To hold English bills will tend to reduce the supply of pounds for sale and thus cause the price of pounds in New York (the rate of exchange) to rise.

Gold Shipments. — As was developed above, the accumulation of large balances in London to the credit of banks in New York will eventually lead to the shipment of gold from London to New York; and the lowering of the balances of New York banks in London will eventually lead to the shipment of gold to London.

The import of gold means, of course, that the claims of Americans on Englishmen exceed the claims of Englishmen on Americans; and the export of gold means that the claims of Englishmen on Americans are in excess of the claims of Americans on Englishmen. The net balance in either case is paid in gold. The situation is essentially the same as when two persons trade goods for goods and settle any difference in value by the payment of cash.

The Postponement of Gold Shipments. — Banks normally do not wish to ship gold to the banks of another city. If it appears that the banks in London, for example, are about to be called upon to ship gold, there are certain expedients by which they may avoid such shipment for a time, and meanwhile the exchange situation may be adjusted so that gold need not be sent. For one thing, as already stated, an increase by such banks of the rate of discount will tend to postpone an outward movement of gold. Foreign banks will be less inclined to call their balances, to ask for gold, as the bank rate rises. And, further, since the rise in the English bank rate would depress the price of time bills in London, foreign holders of such bills would be less inclined to sell them to London banks. At the same time, English banks that hold such bills would be encouraged to sell them to foreign banks. Claims against the English banks

would thereby be reduced below what they would otherwise be and thus the danger of losing gold would be lessened. Then, too, London banks may borrow from foreign banks and use the funds to buy up claims on the English banks. This would check the accumulation of claims against the London banks, and reduce the likelihood of their having to ship gold.

The rise in the bank rate by increasing the expense of borrowing money also tends to curtail the buying of stocks and bonds by local speculators and thus reduces the prices of such securities. This accordingly will increase the purchase from abroad of securities that have an international reputation, and hence reduce the net balance due to foreign banks. The purchase of securities in England by Americans will mean that Americans must purchase drafts on London banks in payment, and the presentation of these at the London banks will reduce the amount due to the American banks that sold the drafts.

The rise in the bank rate will also tend to have a depressing effect upon the prices of commodities and thus encourage their purchase by foreigners. But, save in the case of commodities on the speculative markets, such as wheat, cotton, and corn, a short time change in the rate of interest would normally have no effect upon the volume of sales abroad. Further, of course, this has application only to countries from which such commodities are normally exported.

An increase in the bank rate in one country, as stated above, encourages banks in that country to sell commercial paper abroad. But even without an increase in the rate of discount the banks of one nation may sell such paper abroad in order to prevent the outflow of gold. Such sales obviously reduce the net balance due to foreign banks, and hence reduce the possibility of having to ship gold. The banks that deal in foreign exchange usually keep on hand a quantity of paper that has a ready market abroad in order that they may sell it when necessary to protect their gold reserves. Indeed, the possession of a quantity of such paper makes it possible for such banks to maintain a smaller gold reserve than would otherwise be required. This policy is the same as that followed by banks in

keeping high grade bonds which can readily be sold for cash, if cash be needed, but which meanwhile earn interest for the bank while cash on hand would not.

Gold movements may be controlled by government authorities through the prohibition of gold exportation or by government borrowing abroad. Such action by a government is usually taken only during a very critical period. Both of these devices were freely used during the World War. The present discussion, however, is in terms of normal conditions and thus governmental participation may be disregarded.

The expedients for checking gold exportation which have been discussed above are necessarily only of temporary value. They may enable the banks in one nation to postpone gold shipments until exchange conditions have so altered that they no longer owe large sums to foreign banks. But if there is not such an alteration in exchange conditions, which might come from an increase in the amount of goods sold abroad and a reduction in the amount bought from abroad, the banks must sooner or later send gold in settlement of the claims of the foreign bankers. Indeed, if no change is anticipated in trade relations, the banks will normally not make any attempt to delay gold shipments.

In each of the leading commercial cities gold receipts and disbursements are constantly under way. In 1912 and 1913, for example, to note pre-war conditions, the banks in the United States imported approximately $50,000,000 each year and exported about the same amounts. In October, 1925, a not unusual month, $42,900,000 was received from England and $4,000,000 from Japan, while $22,700,000 went out to Canada, followed by another shipment to Canada of $20,000,000 early in November. Thus gold shifts from one center to another in settlement of the net balances that arise in the course of trade.

Gold Movements Self-regulating. — International movements of gold tend to be self-corrective. An outflow of gold reduces bank reserves and thus tends to cause the rate of discount to be increased. This will reduce borrowing, and, therefore, curtail buying, with the result that prices will fall. The

fall in prices will stimulate foreign buying in the country in question, and at the same time check buying from abroad. This result is made more certain by the fact that the flow of gold into the countries that are receiving it will tend to increase prices in these countries. Thus, any outward movement of gold tends to check a still further export of gold, because of the price changes that thereby occur in the country losing the gold and in the countries that receive it. Normally no nation need fear that through trade it may be deprived of its gold. The adjustment of the prices of its goods that enter into international trade as compared with the prices of such goods in other countries will check the export of gold as soon as the one nation is, relatively to the other nations, undersupplied with gold.

However, in the case of a country that is a heavy producer of gold metal, one should normally expect that there would be a somewhat constant movement of gold to other countries, which movement would not be checked by the forces which have just been noted. In the case of such a country, gold is exported in exchange for other goods as is any commodity in the production of which a community specializes. But in order that gold may be exported, the rate of exchange must be such that banks can afford to ship it to foreign banks for deposit to their credit. How does the production of gold bring about this condition?

The production of sufficiently large quantities of gold in the United States, for example, and its injection into our money supply would raise our price level relatively to prices in other countries. This would stimulate the buying of goods from abroad, and at the same time it would check the buying of American goods by foreign traders. The demand upon American banks for drafts on foreign banks with which to pay for the goods purchased from abroad would increase, and the sale to American banks of claims upon foreigners for goods sold to them would fall off. The balances of American banks in foreign banks would thus decline, and the rate of exchange would rise. Finally, the rate would rise high enough so that the American

banks could afford to ship gold and sell exchange against the balances which were built up in that way. With the constant production of gold in large volume this condition may be expected to remain unaltered. That is, the movement of gold outward will not have the effect of decreasing bank reserves and thus raising the interest rate and lowering prices, as was noted above, because the new production of gold at once replaces the gold which is shipped out.

There may, of course, be special conditions in the commercial life of the people of a nation that will prevent the shipment of gold even when considerable quantities are being produced. Thus in the United States between 1879 and 1900 large quantities of gold were produced each year, but the growth of the country industrially was such that the gold was absorbed into the money circulation of the country without the rise in prices that might have been expected, and which was necessary to lead to an expulsion of some of this gold. Indeed, during this period considerable quantities of gold were imported into this country.

Settlement in New York. — As was indicated earlier, it must not be understood that the settlement of all claims between Americans and Englishmen is made in London in terms of pounds. English banks maintain balances in American banks against which they sell drafts to their English customers, and which they replenish by buying bills drawn by Englishmen against Americans. In other words, some contracts run in terms of dollars and settlement is made in New York.

Obviously, that which is a high rate of exchange on London to New York bankers, is a low rate on New York to banks in London. When the rate is, say, \$4.89, this means that an American must pay \$4.89 for an English pound, but it also means that an Englishman can get \$4.89 in American money in New York for one pound. This is a lower price of dollars to the Englishman than if exchange were selling for, say, \$4.85. But, to repeat, the usual student who is approaching this subject for the first time will find it advisable to think of foreign exchange problems on the assumption that the settlement of

all transactions is made abroad in terms of the foreign currency.

An increasing use of "dollar drafts" has developed since the establishment of the Federal Reserve System. Before 1914, national banks in the United States could not accept foreign drafts drawn on them and consequently both exporters and importers drew bills of exchange on London banks. This was a source of income for the English banks since they charged commissions for their services. American bankers were desirous of having the same privilege extended to them. It is now possible for American banks to accept bills drawn for both export and import purposes and therefore many settlements are now made in dollars instead of pounds.

During and shortly following the European war, drafts on New York banks were used extensively in making payments arising out of international trade. This was due in part to the fact that money here remained the equivalent of gold while the money of most of the other commercial nations did not entitle the holder to receive gold. Thus many exporters and especially American exporters insisted upon payment in New York. Further, as the European nations borrowed heavily here in the form of bank credit this led to their making payment with drafts drawn against their accounts in the New York banks. Many Americans claimed at this time that New York had permanently displaced London as the clearing center of international transactions. Subsequent events have shown that this claim was unfounded, for reasons to be noted in the following section.

London a World Center. — The banks in the various nations that deal in foreign exchange buy and sell drafts on banks in all of the leading commercial cities of the world. London is, however, the chief commercial center. This means that banks and exchange houses in the various countries carry balances in London banks more largely than in banks of other countries, and, accordingly, business firms engaged in international trade make extensive use of pound drafts on London in the settlement of debts even when neither of the parties to a transaction is located in England. Settlement in this way through London

banks is similar, of course, to the use of a draft on a New York bank as a means of payment between two firms neither of which is located in New York.

It follows from this that the rate of exchange in one city, New York for example, on the banks located in a foreign city, London, does not necessarily indicate the state of trade relations between the persons living in the two countries. That is, a high rate of exchange in New York on London does not necessarily mean large payments to Englishmen for goods purchased or services received from Englishmen by Americans. Such a rate may result, for example, from heavy American purchases of coffee from Brazil, or from American loans to Mexican firms, or from the importation of silk from Japan, for in each of these cases American firms, or banks, would normally buy drafts on London banks to be used in payment for the goods or bonds that were purchased.

The function which is performed by London banks in international settlements depends for its fulfillment upon an adequate supply of banking funds and the ability of banks to perform the services incident to exchange operations at a low cost. Further, it is necessary that the banks performing this service should be located in a city in which a relatively large volume of international trading takes place. The banks of London have thus far had advantages in these respects over the banks of any other commercial city. This together with the difficulty of overcoming an old habit makes it seem likely that London banks will continue, for a long time to come, to act as clearing houses for international trade. The pride of nationalism is undoubtedly overdone in connection with this matter. Whether the London banks or those of New York act as clearing centers is really of very little importance to either Americans or Englishmen.

Arbitrage in Foreign Exchange. — The buying and selling operations in foreign exchange that are carried on by banks and exchange houses are, of course, conducted with a view to making a profit from the transactions. The rate of profit expected in any one purchase or sale is very small, but in the aggregate

the gains may represent a handsome profit on the amount of money employed during the course of a year. For example, a profit of only 1/36 of 1 per cent on a transaction of a given amount each day will yield 10 per cent profit on that sum in the course of a year. The seeking of profit in this field, as in the case of commodities, leads to what is called *arbitrage* — the buying in one market where exchange is low and the reselling in another where the exchange is higher. That is, New York banks and exchange houses, for example, not only buy and sell pounds, francs, marks, lire, yen, and other foreign currencies, in the form of commercial bills and bank drafts, to their American customers, but also buy and sell them in the various cities of the world as opportunity offers to make a profit. Likewise, foreign exchange dealers in each of the leading commercial cities buy German marks in Rome, for example, if they can resell them in some other city to advantage. This constant watch upon the prices of bills in the different cities, and the selling and buying that result therefrom tend to maintain uniform prices for each currency in all of the commercial markets, and at the same time tend to give the lowest possible prices to individuals and firms that need to buy foreign exchange, and the highest prices that are warranted to individuals and firms that have foreign claims to sell.

Illustrations from the War Period. — Foreign exchange operations may be copiously illustrated by reference to the period of the World War and the time immediately following it. The few illustrations to be given will be taken largely from London–New York exchange. Shortly following the outbreak of the war the rate of exchange on London rose to $7. This meant, of course, a strong desire to convert dollars into pounds. This was due to the fact that many Americans were abroad at this time and were very anxious to return home and were without sufficient English money to purchase passage but had funds in American banks. They accordingly bid high for English money. Also, friends and relatives in this country desired to send money to the stranded Americans and sought to buy pound drafts for this purpose. Another factor in the situation

was the fear that German warships might make it impossible for American banks to send gold to London to build up balances against which Americans were attempting to draw.

This panic was soon over, however, and the rate of exchange returned to normal. But the foreign governments and foreign traders began buying heavily in our markets, purchasing food, clothing, and munitions of war. At the same time the people of the European nations turned from the production of peace-time articles, which they had been exporting to this country, to the prosecution of war. Thus the net claims against the Europeans greatly increased, and consequently the price of claims — the rate of exchange — fell to the low gold point and large quantities of gold were sent from Europe to America. The gold movement from England was delayed somewhat by the sale in New York of large quantities of American stocks and bonds that were owned in England. Such sales were encouraged by the English government, and amounted to an exchange of such securities for American goods. It was in this way that "America got out of debt to Europe," to repeat a much used expression.

Very shortly, too, the export of gold from England was prohibited, and the payment of gold within England to the holders of bank paper was discontinued by the Bank of England. This meant that both locally and internationally the English pound had become a paper pound. The purchase by New York banks of claims on Englishmen no longer entitled them to get gold in London. The rate of exchange then fell rapidly, reaching \$4.48 during the autumn of 1915. In terms of pounds, this meant that the dollar had risen considerably. To buy munitions valued at, say, \$10,000, required many more pounds than if the pound had been at par. Or, if sales were made in pounds a higher price needed to be charged in order to net the seller the number of dollars that he would have received for his sale if the pound had been at its normal value.

The English government then made provision to support the value of the pound in our markets. It borrowed privately at first, and used the proceeds to buy sterling (pound) bills at about \$4.76½. During most of 1916 and until the United States

declared war in 1917, the banking house acting for the English government purchased sterling exchange to an amount averaging $10,000,000 a day. After the entrance of the United States into the war many billions of dollars were loaned to the English government by the American government and were largely used to buy up bills against Englishmen and against the English government. In this way English exchange was protected or "pegged." The effect of the government's policy was clearly seen when the purchase of English exchange at government order was discontinued in the first year following the war. On the morning of March 20, 1919, J. P. Morgan and Company announced that it would no longer buy at a fixed price all of the English exchange that was offered, and immediately the rate of exchange fell. Within a week the price declined 14 cents and by the following February it had reached $3.20.[1]

The Rate of Exchange under a Paper Standard. — When the English government withdrew its support from the exchange market in New York, the rate of sterling exchange became subject to the influences that determine the rate of exchange on a country that has a paper money standard. The rate in such a case is determined by the supply of and the demand for exchange on the given country, as is true when the gold standard prevails. But what are the factors that determine supply and demand? In the case of exchange under the gold standard, an outward movement of gold from New York to London, for example, augments the supply of exchange on London and thus prevents demand forces from bidding the price above the gold export point; and an inward movement of gold prevents the supply of exchange from depressing the price below the gold import point. Within these two points, the rate fluctuates as demand and supply vary, that is, as the buying and selling of goods and services, the lending and borrowing of money, and other transactions call for the transfer of funds.

The rate of exchange under a paper standard is similarly determined, except that gold movements do not confine its fluctua-

[1] Cf. B. M. Anderson, Jr., "Artificial Stabilization of Exchange Condemned," *Chase Economic Bulletin*, Vol. II, No. 1, 1922, p. 15.

tion within fixed limits. Supply and demand conditions might place it either high or low relative to what it would be under a gold standard.

The major demand for exchange arises normally as a result of purchasing goods in the country in question, and the supply comes from the sale of goods to persons in the given country. The buying and selling between countries is conditioned (1) upon the price levels in the two countries, especially the prices of exportable goods, and (2) the rate of exchange. With given prices for exports, in England, for example, any fall in the price of pounds might be expected so to stimulate the purchase of goods by foreigners that the increased demand for exchange would check the fall in the rate, and at the same time so curtail selling into England that the supply of exchange would fall off, thus also tending to stiffen the rate. That is, the rate of exchange might be expected to be adjusted to the prices that prevail in England as compared with the prices in America. In other words, the value of a pound in New York might be expected to depend upon what a pound would buy in England, as compared with what dollars would buy in America.

Experience shows, however, that the rate of exchange on a country that has a paper money standard is not always determined by the quantity of exportable goods that can be purchased with a unit of the paper money. There was a period following the World War, for example, when the price of French exchange was considerably below the point that was warranted by the prices of French exportable goods in relation to the prices of similar goods in the world's markets. This situation greatly encouraged the purchase of French goods by foreign traders. Incidentally, this alarmed the manufacturers of similar goods in England, since they could not afford to sell at a price that would meet this competition. The abnormally low rate of French exchange at this time was not caused by the fact that sales into France, by the English and others, had been heavy, thus creating a large volume of French exchange and depressing its price. But the low rate must have come from an increase in the supply of French exchange. From where did it come?

The answer is that it came as a result of dealers in exchange having sold French exchange short.

The exchange dealers and other speculators sold exchange short because the financial condition of the French government made it seem probable that the value of the franc in the French markets would fall in the near future. For if the value of the French currency were to fall — if French prices were to rise — the price of French exchange would fall. Hence, since it seemed to speculators that this was going to happen they felt that a profit could be made by selling French exchange short — by selling it for delivery at a later date. This depressed the price of francs (the rate of exchange) below the point that tended to be established as a result of the level of prices of export goods in France as compared with the prices of similar goods elsewhere.

The effect of speculative dealing in exchange as a factor in determining its price may be further illustrated by reference to English exchange. When the English government ceased its "pegging" operations in New York, English exchange dealers began selling pounds short in New York. That is, they drew drafts on themselves, or on English banks, payable, say, in 90 days, and sold these in New York. At the same time, New York dealers drew drafts on English banks payable at some future date and sold these. The supply of pound claims was thus augmented and the rate depressed. Both English and American dealers expected to "cover" the drafts sold when they were due with pounds purchased at a lower price, and thus make a profit. The English dealers held the receipts for their sales in New York banks, in dollars, and thus as pounds fell in terms of dollars, were able to buy back more pounds than were sold. The New York dealers operated similarly. And so long as it was expected that the pound would fall still further, such short selling was continued. But when it came to be expected that the gold standard was to be resumed, the price of pounds rose as a result of speculative buying. By the time that the announcement of the return to gold payments was made (April 28, 1925) the pound had risen to $4.82, and immediately following the announcement the rate rose to the low gold point.

Similarly, speculative dealing in dollar exchange during the American Civil War affected the price of dollars in terms of foreign money. Any change in military conditions during this time caused speculators to alter their bids to buy or their offers to sell paper dollars. Obviously, the time at which the United States government could be expected to redeem the paper dollars in gold depended upon the fortunes of war, and thus the value of paper dollars was affected by the trend of military events.

The above illustrations are all taken from conditions in which the value of the paper money in question is expected to change in the future. It is the anticipation of change in money value that leads to the establishment of a price for such money — a rate of exchange — that at a given time is not the price that foreign traders might be expected to pay for such money in view of the prices of the goods that might be purchased in the country in question and exported to other countries. But if a country should have a paper money standard that was regarded as a permanent thing, and if the level of prices that prevailed should be expected to be subject to but little, if any, fluctuation, the rate of exchange on that country would be determined by the prices of exportable goods from that country as compared with the prices of similar goods that could be secured elsewhere.

German Reparations. — The foreign exchange problem involved in the payment by Germany of the sum of money assessed upon her by the victorious Allies, and commonly referred to as *reparations,* is very interesting. Under the Dawes plan, which was inaugurated in July, 1924, it is definitely recognized that there are two problems in connection with getting payments from Germany. One is the collection of funds in Germany and the other is the transfer of these funds to the nations that are entitled to receive reparation payments. The first of these does not concern us here. Suffice it to say that there is no difficulty on that score. But how transfer the funds to the other nations? Particularly, how can this be done without depreciating the value of the mark, and perhaps causing another period of financial and industrial chaos in Germany?

To send drafts on the Reichsbank, which holds the funds secured by taxation, to the allied governments would be the first step in making money payments. A government receiving such drafts would wish to sell them for its own currency. In France, for example, the importers of goods from Germany would buy these drafts from the government with francs. Banks, of course, might be the immediate purchasers.

If the drafts were offered in excessive quantities two things would happen. First, the price of the mark would fall below its new gold value, 23.8 cents in American money, and secondly, this would make the buying of German goods so profitable that traders would bid up the prices of German exports. The new prices on exports would then tend to be reflected to the prices of other goods within Germany and this might start a business "boom" which through increased borrowing at the banks and a still further rise of prices might lead to another calamitous period of inflation.

It is only, then, as such a limited number of marks are transferred to the allied governments as can be used for the purchase of German exports at normal gold prices that disastrous results can be avoided. Further, in so far as German firms buy goods abroad, the drafts on German banks in payment of these purchases will augment the supply of marks for sale, and thus further limit the number of marks that the allied governments might sell without depreciating the mark both outside and within Germany. In short, it is only as the German people export goods in excess of their imports that reparations are possible. Or in other words, it is only in exports of goods that Germany can make payment.

If Germany had sufficient gold to pay the reparations, then the transfer of bank drafts in marks to the allied governments, the sale of them to local banks, their decline in value to the gold import point, and the importation of gold from Germany would settle the matter. But Germany does not possess sufficient gold to make this at all possible. Indeed, to maintain the gold standard within Germany the present stock of gold must be preserved.

The direct transfer of goods by the German government avoids any reckoning with foreign exchange. This is a special method of payment by exports. Under the Dawes plan a somewhat considerable payment is to be made in this manner each year.

The enormous indemnity, for that time, that was imposed upon France by Germany at the close of the War of 1870 was paid very largely by the French government's giving new issues of government bonds to French citizens in exchange for foreign stocks and bonds which they held. These securities were then sold by the French government, very largely in the countries from which they originally came, and bank credit was taken in payment. This bank credit was then transferred to the German government and by it sold to the German banks, whence it found its way to importers of goods into Germany.

The exchange problem then differed markedly from that prevailing now relative to the German indemnity, because, for one thing French industrial relations had not been disturbed by the preceding war, which had been of short duration. Further, the amount demanded then did not exceed the capacity of the French people to pay, while according to many careful experts the demands upon Germany are entirely beyond her capacity. That is, it is claimed that the German people cannot export a volume of goods sufficiently in excess of their imports to permit the payment of the huge sums that are demanded.

PROBLEMS AND EXERCISES

11. An American exporter of wheat to Liverpool normally sells to a New York bank the pounds sterling that are due him in London.

(*a*) Write out the substance of the piece of paper that he sells to a New York bank.

(*b*) What does the New York bank do with this piece of paper?

(*c*) In general what conditions will determine the amount per pound sterling that the bank will pay the exporter for his claim?

(*d*) Will much or little exporting by Americans relative to the volume of importing tend to lower the price in New York of pounds sterling in London, that is, the rate of exchange on London in New York? Why?

(*e*) Will a high price (high rate) in New York for English pounds sterling in London, or a low price, encourage traders to sell goods abroad? Why?

12. "By the mechanism of bills of exchange, the exports of grain from the United States to England serve to pay for the imports of coffee from Brazil to the United States; and these same shipments of coffee viewed as exports from Brazil serve to pay for Brazil's imports of manufactures from England." Explain how "the mechanism of bills of exchange" has these effects.

13. Excessive exports tend to bring about a rate of exchange that will check exporting and stimulate importing. Explain.

14. Will the following tend to raise or lower the rate of exchange on London in New York? Explain.

(*a*) An increase in exports of goods to England? To Italy?

(*b*) An increase in the importation of goods from England? From Brazil?

(*c*) European travel by Americans?

(*d*) American travel by Europeans?

(*e*) Borrowing abroad by selling American securities?

(*f*) Buying of postal money orders to be sent to Europe?

(*g*) An increase in the discount rate in London? In New York?

15. Consult the daily newspaper and find the current rates of exchange in New York?

16. (*a*) Under normal conditions, at what rate of exchange in New York on London will gold be shipped from New York to London? Why will gold normally not be shipped unless the rate reaches this point as it moves away from par?

(*b*) Answer the same question relative to movement of gold from London to New York.

17. Importer A wishes to buy a bank draft for £5,000 on London. What will he have to pay for the draft if London exchange is at $4.847? at $4.867?

18. An exporter of wheat in New York draws a bill on one of his London customers for £2,450. If London exchange were selling at $4.846 what could the exporter get for this bill? if London exchange were selling at $4.887?

19. Suppose that a New York importer can get 50 gross of Sheffield razors delivered in New York for 44 pence each (the tariff duty included), and that he can sell them for 95 cents each. What would be his profit on such a transaction, if the rate of exchange on London were $4.84? if the rate were $4.87? (Taylor.)

20. Near what point would you expect the rate of exchange on London to be found in the fall of the year? Why? (Taylor.)

21. If nations do not impose restrictions on the free movement of gold the supply of gold will automatically adjust itself to the needs of the country. Start with a country mining a great deal of gold and enumerate the steps by which gold would come to be exported.

REFERENCES

One of the leading books dealing with this subject is *Foreign Exchange*, by E. S. Furniss, 1922. G. Cassel in his book, *A Theory of Social Economy*, 1923, gives a good discussion of foreign exchange. H. G. Moulton, of the Institute of Economics, in collaboration with other writers, has published the following books dealing with the exchange problems that have grown out of the war: *Germany's Capacity to Pay; Russian Debts and Russian Reconstruction; The Reparation Plan;* and *The French Debt Problem.* See also the books listed in the appendix.

The monthly bulletin issued by the National City Bank of New York and the *Commerce Monthly* issued by the National Bank of Commerce of New York have interesting current material relative to the prevailing rates of exchange. These are sent free to anyone requesting them.

Special bulletins of the Chase National Bank are occasionally devoted to foreign exchange. These also are issued gratuitously.

CHAPTER XXXIV

FOREIGN TRADE POLICY

Trade and Specialization. — The fundamental nature of trade was discussed in the earlier portions of this book. It was pointed out that in a society in which the principle of private property prevails, trade is essential to the specialization of tasks, for men can devote themselves to specialties only when it is possible to exchange products with each other. The degree to which specialization can be carried thus depends upon the extent of trade. As was emphasized in Chapter IV there has been an increasing development in the extent of trade relations, and thus also in the degree of specialization, during the past several centuries. Our present day economic organization is in marked contrast in these respects to that of any preceding period. Not only are the trade relations within communities and nations highly developed to-day, but there is also a vast amount of trade among the people of the different nations.

The nature of trade is in no way affected by the existence of political boundary lines. Foreign trade and domestic trade are exactly alike as elements in the specialization of economic activity. Foreign trade, however, is usually given much different treatment by citizens and politicians from that accorded to domestic trade.

Contrasting Policies Relative to Exports and Imports. — The benefits that normally come from the specialization of economic tasks are such that one might expect that the people of the various nations would give every encouragement to the development of foreign trade. Indeed, this has been almost universally true so far as the selling side of foreign trade is concerned, but as will be developed presently, it has not been true of the buying side of foreign trade. In other words, the usual policy that has been followed by the various nations has been to

encourage the sale of goods to the people of other nations, but to discourage the purchase of goods from them.

It has always been the policy of the United States government, for example, to encourage the marketing of goods abroad. Officials known as consuls are stationed in all of the principal commercial cities of the foreign nations and are engaged solely in furthering the export interests of persons and firms in the United States. Considerable sums of money are also spent in dredging harbors, building docks, maintaining lighthouses, and providing cables and other means of communication that American goods may be sold in foreign countries. In addition, a proposal is frequently made that a subsidy be paid by the United States government to vessels sailing under its flag, in order that, among other things, the export of goods from these shores may be facilitated. Recently the anti-trust laws of the country, which are designed to prohibit the formation of monopolies, were amended by the passage of the Webb-Pomerene Act (1918) so as to permit the forming of monopolies for the purpose of selling goods abroad.

Our national policy in respect to the encouragement of exportation is typical of the policy that prevails in other nations. How different is the usual policy in regard to the importation of goods! To discourage or prevent the purchase of goods from outside a nation's boundaries has been the aim of almost every generation of lawmakers in the various nations since the beginning of commercial life. The favorite device for the accomplishment of this purpose has been the imposition of a fee — a tax, or a duty — upon the goods that are imported. The charges, or duties, so imposed are commonly called tariff duties or tariffs. The word *tariff* is of Spanish origin and means a list or schedule of rates.

In the United States, almost from the beginning of our national existence, duties have been levied upon the importation of goods. The duties imposed have varied from time to time in amount and the list of goods subject to duties when imported has also varied, but the national policy has consistently been to restrict the importation of goods into the country. Thus

our national policy in regard to international trade has been to foster selling abroad but to restrict buying from abroad.

How can the difference in attitude toward the export and import trade be explained? Are these two lines of policy consistent? Is each advisable? Particularly, for it is upon this question that controversy centers, is the policy of imposing restrictions upon imports desirable? Or, would it be well to remove tariff barriers and to permit foreign goods to be sold freely in our markets? That is, should we adopt the policy of free trade? Finally, does the trend of events indicate that our policy toward imports is likely to be altered? These questions will be given consideration in the following discussion.

Restrictions upon Local Buyers. — The federal Constitution prohibits the levying of import or export duties by any state in the Union. Thus trade among the states is free from legal restrictions. Hence except for the non-legislative restrictions which will be noted presently, the cost of transport is the only effective barrier to trade among the various sections of the nation; and as the cost of transportation has been reduced to an amazingly low figure, as noted earlier, the volume of domestic trade has reached tremendous proportions.

Although there are no legal restrictions upon our domestic trade, there are, as just suggested, restrictions that are extra-legal, or non-legislative. In perhaps every community, the buying public is urged to patronize local stores and to resist the appeals of mail order houses and the advertisements of dealers in other places. Pressure of this sort is applied, too, to secure patronage for local professional men, banks, insurance companies, laborers, and local dealers and companies of all sorts. Similarly, state officials often urge the people of a given state to buy certain "home" products rather than those from outside the state. These local forms of pressure are of the same nature, although less effective than the levy of duties upon importation. The object is to preserve the local, or the home, selling market for the "insider" as against the "outsider".

Self-interest in the Advocacy of Protection. — The pressure that is thus applied to local buyers in favor of local sellers gives

a clew to the most important source of the demand for tariff duties. All groups find it decidedly to their interest to reduce competition in the markets in which they either buy or sell, as has been emphasized in the earlier portions of this work. Obviously, one way to reduce the competition that sellers must face is to exclude competitive sellers from the selling market. If it were legally possible for the coal producers of Ohio to be protected against the coal producers of Kentucky and West Virginia by the imposition of a heavy tax upon all coal entering Ohio, one may be very sure that the demand for such protection would be made. If it had been legally possible to keep out of New England the agricultural produce of the West, or to admit it only on the payment of heavy duties, there is no question that the agricultural interests of New England would have demanded such protection as the extension of the railways brought the fertile lands of the Mississippi valley into effective competition with the farms of New England.

The insistence on the part of chemical manufacturers of this country that they be protected from competition with chemical producers in Germany, and the demand by sugar producers that they be similarly protected against the competition of sugar producers outside of the country, to mention only two of the many lines of work for which protection is demanded and received, is clearly to be expected from such groups.

It is thus from the self-interest of the leading business men in the industries that suffer, or would suffer, from the competition of foreign goods in the home market that the principal element in the demand for a protective tariff is found. But in addition to the various groups whose self-interest has prompted them to advocate the policy of curtailing imports, there have been many able and disinterested persons who have advocated such a policy as a means of promoting national well-being.

The Arguments of Protectionists. — Many arguments have been advanced in favor of a policy of protection. It has been contended that protection increases the opportunities for the employment of labor; that it raises wages, or maintains wages at a high level; that it diversifies industry and thus gives scope

to talent; that it is a necessary feature in developing industries that will eventually not need protection; and that it makes a nation self-sufficient in the midst of its possible enemies. These defenses of protection will be considered presently.

The Fundamental Effect of Protection. — Before analyzing the various claims of the advocates of protection, it will be well to consider the fundamental effect of this policy. It is only in this way that the arguments for and against protection can be understood. The purpose of a protective tariff is to protect the producers in certain industries from the competition of foreign producers in the home market, in order, so it is argued, that such industries may exist in the given country. Without the tariff, then, the industries in question would be prevented from coming into existence, or would be crowded out if they were under way when the foreign competition appeared. Sometimes a protective tariff may merely protect the large profits of certain producers against the inroads of foreign competition. But such a tariff situation is never defended by the advocates of protection.

The validity of protection thus depends upon the advisability of maintaining within a country lines of industry that under free trade would have to be abandoned because of foreign competition. Thus, since if one kind of industry cannot be followed by the people of a nation another one must be, for a people cannot remain idle, a protective tariff means the substitution of certain lines of industry for other lines of work. A protective tariff, then, shunts labor and materials into given fields of employment and away from others. It directs the economic forces of a nation into channels that would not be followed under a policy of free trade. This, indeed, is the avowed purpose of protectionists in the advocacy of their program. The thorough appreciation of this fact will aid one in understanding a large part of the controversy over the protective tariff.

The Discriminatory Feature of Protection. — A policy of giving protection to certain industries may then be phrased in terms of discrimination among the various lines of enterprise. To protect the producers in some lines is to discriminate against the producers in other lines.

(1) *Labor and Materials Diverted to Protected Industries.* — To enable labor and materials to be used in lines of enterprise that would otherwise not be undertaken, must mean that the labor and materials thus used are kept from employments in which they would have engaged if protection had not been afforded to the particular industries. In terms of the entrepreneur, the result is that those business men who are in non-protected enterprises are not able to purchase materials and hire labor that were formerly available. The fact that the industries that are thus discriminated against by a policy of protection are usually of great variety and extent obscures the fact that the policy is to their disadvantage. The aid to the protected industries is clearly seen — but the resulting disadvantage to the other lines of work is not usually observed.

(2) *Competitive Advantages of Certain Home Industries Removed.* — The discrimination against the non-protected industries may be stated in terms of competition among the home industries. All industries — all lines of work — as was pointed out in an earlier chapter, compete against each other. If it does not pay to carry on a certain enterprise, this is on account of the fact that it pays better to do something else. If wages are too high, or interest too high, or rent too high to make it profitable to produce a certain product, this means that other lines of production are more profitable, else wages, interest, and rent would not be so high as they are. A demand for protection then, on the ground that entrepreneurs cannot compete against foreign producers in a given line of industry, really means that the work in question cannot compete against other lines of work that are being carried on in the country where protection is requested. Protection would make it possible for such work to be carried on by raising the price of the product of that industry sufficiently to permit entrepreneurs in that line of work to pay as much in wages, interest, and rent as can be paid by the entrepreneurs in the accustomed lines of enterprise. This would mean a discrimination against the lines of work that had formerly been able to outbid the new — the protected — line of work in securing labor, capital, and land.

(3) *Export Industries Curtailed.* — Another way of noting the discrimination against certain fields of industry is by considering the effect that protection has upon the export industries of a nation. Trade is reciprocal. Goods and services can be sold only if goods and services are bought. Or, since the services that are the subject of purchase and sale among the people of different nations, as, for example, the services of transportation firms, insurance companies, and money lenders, and the services rendered to tourists, are not usually of great importance when compared with the quantity of goods bought and sold, they may be neglected in the analysis. Further, as the principles that are applicable to the exchange of goods are also true of the exchange of services, the analysis is not altered by speaking only of the exchange of goods. Briefly then, the people of one nation cannot sell goods to the people of other nations if they will not in turn buy goods from foreign traders. Foreigners cannot buy from us if we will not buy from them.

In opposition to this position it is often contended that the people of a nation may sell abroad and receive payment in gold. It is, of course, possible that this may be done, but the limits within which such trade can be carried on are very narrow. Selling abroad depends in any case upon quoting prices that are low enough to attract foreign buyers. Assume that the prices quoted by export merchants in country X are satisfactory and that the making of payment through the usual banking channels leads to the importation of gold, on account of the failure of persons in X to buy goods abroad, following the imposition of a protective tariff. If the sale of goods and the importation of gold are continued, the accumulation of gold in the banks of the given nation, X, will tend to raise prices in that nation, and at the same time the removal of gold from the banks in the other nations will tend to lower the prices that prevail there. The rise of the prices in X will force the export merchants to quote prices to foreign buyers, and, at the same time, the fall of prices in the markets of other nations will make the dealers who have been buying from the exporters in X not only less anxious, but less able, to purchase even at the former low prices. The result

will be a cessation of selling to foreigners by the merchants in the given country. It is thus impossible for the people of a nation to sell goods to foreigners and take payment in gold, unless it is done on a very small scale. International trade is essentially barter. The curtailment of imports thus leads to the curtailment of exports.

Further, the amount of foreign trade is so large as compared with the stock of money gold that sales of goods for gold by the people of a large nation could not long be continued. The exports of goods from the United States for any three recent years exceed the total supply of money gold of the world. Over half of this total supply of money gold is already in the possession of the people of this country. Clearly the opportunity for our citizens to sell goods abroad for gold is sharply limited.[1]

It may also be claimed that goods may be sold abroad on credit, and thus that importation does not necessarily depend upon exportation. This, too, is possible, but it is also subject to sharp limitations. Such a policy would mean the exchange of goods for promises to pay later, that is, for bonds and other evidences of debt. Such exchanges may continue for some time. Indeed, in the nine years since the conclusion of the World War, the people of the United States have sold abroad for promises to pay some $13,000,000,000 of goods. This is sometimes phrased in terms of our having loaned such a sum of money abroad, or of our having exported such a sum of capital. What has happened is that some Americans have purchased foreign bonds and mortgages to this amount, and that other Americans, or in some cases the same persons, have sold goods to foreigners. Thus the American lenders have paid the American exporters for $13,000,000,000 of goods sold abroad in excess of goods imported. As a nation we have exported goods and taken payment in bonds and other promises to pay.

But such sales on credit cannot continue indefinitely. As the volume of the debts owed to our citizens increases, the yearly interest accruals will likewise increase. Interest accruals may be invested abroad for a time. That is, notes, bonds, and mort-

[1] Compare S. A. Rufener, *Principles of Economics*, 1927, p. 691.

gages may be accepted as interest payments, but eventually the opportunities for further investment by Americans will be less profitable; or, to state the matter differently, Europeans will offer less favorable terms for loans. In other words, bonds on foreign industries will be less readily sold in our markets. The reduction in the volume of such bond sales will reduce the demand in our markets for bills of exchange on foreign banks. This will depress the price of foreign bills and thus at the same time discourage the exportation of goods and encourage the importation of goods. Also, the sale in our markets of coupons calling for the payment of interest to Americans by foreigners will depress the rate of exchange and tend both to encourage the importation of goods and discourage exportation. Thus we cannot continue to export goods and take payment in foreign credit. Unless goods are imported the export of goods must cease.

Even if profit-making opportunities as reflected in prices here and abroad, and the rates of exchange, made it possible to continue indefinitely to sell abroad on credit, it is difficult to see how such a policy could be defended from the point of view of national interests. It would amount to the production of goods here and the sending of them abroad with the understanding that they were never to be paid for — that only mortgages and bonds were to be given in exchange, with still more mortgages and bonds to be given later as interest payments fell due. If the people of a nation are to receive an equivalent for goods exported, either goods must be imported, or the services of foreigners must be imported. The importation of either bonds or gold is not equivalent in terms of welfare to goods exported except as they are used later to procure imports of goods or services.

The conclusion is then that exports cannot flow out unless imports come in, save during short periods of time. To refuse to buy from abroad thus means that we cannot sell abroad. To levy a protective tariff and thus prevent foreigners from selling in our markets must mean that we are at the same time preventing persons who would otherwise export American goods from

having the opportunity to do so. In other words, when we discriminate in favor of certain home producers by shutting foreign producers out of our markets, we at the same time discriminate against other home producers by shutting them out of foreign markets. It is thus, of course, that industry is forced into new channels as protective tariffs are imposed.

It is reasonably clear that the agricultural industry in America suffered severely following the close of the World War due to the fact that our tariff policy prevented the people of this nation from buying goods from Europe that would have permitted the people there to buy the agricultural produce which they solely needed and which our farmers were anxious to sell. In effect, a policy of free trade would have permitted the farmers in America and the manufacturers abroad to exchange their goods to the mutual advantage of both parties.

That this relationship between exports and imports is not understood, although it is very simple in its main outlines, is evidenced by the almost universal policy on the part of governments of encouraging the one and discouraging the other, as noted at the beginning of this chapter. Lavish expenditures are made in order to make it possible to sell goods abroad and then the outlay is made worthless, so far as it is possible to do so, by excluding from the home markets the goods that are the necessary basis for the continuance of purchases from our exporting merchants. In this practice of beckoning foreign trade with one hand and repelling it with the other, the United States has long held a conspicuous place among the nations of the world.

(4) *Consumers of Protected Articles at Disadvantage.*—The discriminatory feature of a protective tariff is especially apparent if the effect upon the consumers of the articles that are subject to protective duties is considered. The prices of such articles are certainly higher than they would be otherwise. Indeed, this is the avowed purpose of levying the protective duties. They are imposed in order to keep out foreign goods and thereby raise the prices of similar goods in the home market sufficiently to make it profitable for such goods to be produced at home.

If the duties do not lead to higher prices in the home market they do not furnish any protection.

Hence, to argue, as some of the advocates of protection occasionally do, that such a policy does not result in consumers' having to pay higher prices for the articles subject to import duties, is to make the argument for protection meaningless. If the prices of the protected articles are not higher under the tariff, if they would not be reduced if the tariff should be removed, then it is clearly nonsense to retain the tariff in order to protect home producers.

The Fallacy of Increased Employment. — The proponents of a policy of protective tariffs insist, among other things, that such a policy increases the volume of employment. "Free trade gives jobs to the foreigner: protection gives jobs to the folks at home," is a familiar form of the statement. This is clearly unsound. Whether there be much or little trading across the national boundaries, the volume of employment tends to be the same. The normal tendency is for most of the workers of a country to be employed most of the time. Unfortunately, changes in the supply of and the demand for the various products of industry seem to make some unemployment unavoidable, and perhaps also the desire to "lay off" from work contributes to chronic unemployment. But these factors are not conditioned upon the degree to which trade takes place across boundary lines. Free trade England in the pre-war period did not have any greater percentage of unemployment than did Germany where the policy of protection prevailed.

Clearly, the lines of enterprise are not the same under protection as they would be under free trade. Thus many persons do not have the same kinds of jobs in the one case that they would have in the other, but there is not the slightest reason for believing that more jobs would be available under one policy than under the other. To be sure, there may be a depression in some one industry with consequent unemployment, and the shutting out of imports in that line might add to the volume of employment. If it were possible to exclude from the state of Ohio the coal now (1928) coming in from the south of the Ohio

River, miners that are now unemployed would be given work. But certainly the people of Ohio could not increase the average amount of employment per decade by cutting off all trade with the other states of the Union.

A more defensible position in regard to the volume of employment is taken by protectionists when they argue that there is less danger of temporary unemployment under the one policy than under the other. The argument is correctly based upon the assumption that under free trade the industries of a nation are adjusted to foreign commerce in which both exports and imports play a part, while under protection the industries of a nation are largely adjusted to trade relations with each other, foreign trade being reduced to a minimum. The contention is that with the industries of a nation dependent upon foreign markets for the purchase of raw materials and the sale of products there is more likelihood of disturbance than if the interdependence of industry is very largely confined within the bounds of the nation.

Against this position the argument can be advanced that the breadth of the world market makes it less uncertain than is the home market. Poor business conditions in one country might not deprive an exporter, or an importer, of opportunity to do business, for he might be able to turn to some other country, but with industries dependent solely upon home markets, a crop failure, for example, might seriously affect all of the industries of the country. The pre-war experience of free trade England, to refer to it again, does not warrant the conclusion that trading in foreign markets leads to greater interruptions of business than if trade is largely domestic.

The Fallacy of Increased Prosperity. — The fact that a tariff policy directs the economic activities of a nation into lines of enterprise that would not otherwise be followed throws light on the question as to the effect of such a policy on the prosperity of a country. If we assume that consumers spend their money wisely and thus ably direct economic forces, it will follow that the alterations of the lines of economic activity, by the imposition of a tariff will result in a less satisfactory direc-

tion of economic effort. This assumption is not universally valid. The consumers who happen to possess buying power will not necessarily direct economic activity into the lines that it is best for it to follow.

In order to devote the economic forces to the best service of the society a very considerable degree of control may be advisable. Protection against imports is one form of control, and it may be justifiable under certain conditions. But protection almost necessarily reduces the total output of goods. Its object, in fact, is to keep certain goods out of the country, and to lead to the production of similar goods within the country. But this will mean the curtailment of production in other lines, and, to repeat, the sum total of goods available for use in the country will tend to be less than if free trade prevailed. If this were not true — if as many goods were available under protection as under free trade — prices of the protected goods would be no higher under protection and hence protection would be of no avail. This point in regard to the effect of a protective tariff on prosperity will be made clearer by the orange growing illustration which is given at the close of this chapter.

The effect of a policy of protection upon prosperity may be obscured by other factors. The United States has from the beginning been a prosperous country as compared with the other regions of the world. We have had a protective tariff policy during almost all of our national existence, and it has seemed to the unobservant that there is a causal connection between these two phenomena. This conclusion has undoubtedly not been warranted. There are many reasons to explain our high degree of prosperity other than the prevalence of a protective tariff policy. Furthermore, for the reasons given above, one should expect that the degree of prosperity would have been still higher if it had not been for our policy of protection.

There is one way in which a protective tariff may increase the prosperity of a country. When a protective tariff is enacted to check the volume of goods flowing into a country, the volume of exports is normally not affected at once, and in order

that payment may be made for these, it is necessary that gold be sent in. This influx of gold, as a result of a sudden cessation of importing, tends to raise prices somewhat in the country concerned, and this tends to encourage business enterprise. The result of this may be a higher degree of prosperity than would have prevailed if the imports had not been thus restricted and gold imported in payment of the goods which continued to be exported. As noted above, this method of paying for exports cannot long continue, but if it continues only for a short time, the results may be a rather considerable increase in the degree of prosperity. Obviously, this is not a tariff policy that a nation could follow permanently since its value depends upon the sudden termination of imports and comes from the results of a relatively short period of trading following such restriction of imports.

Wages under Protection. — It is commonly maintained by the advocates of protection that such a policy results in high wages being paid to workingmen. The discussion in the preceding section, however, points to the opposite conclusion. If the total output of goods is made less by diverting labor and materials into less productive lines than would be followed under a policy of free trade, then certainly the laborers of a country would be in a less favorable position under protection than under free trade.

A very interesting shift on the wages question has been made by the advocates of protection in this country. When the protective tariff policy was being inaugurated, during the first decades of the past century, it was argued that a tariff was necessary because wages were high in this country. High wages here, it was contended, made it necessary to give protection to manufacturers so that they could compete against the foreign manufacturers who did not have to pay such high wages. Later, after the policy was established, it was argued, as it is to-day, that wages are high in this country because of the policy of protection. This latter position is, of course, not sound if the analysis in the above paragraph and in the preceding section is correct.

It is often argued that the import of goods from low wage countries will tend to lower wages in the countries receiving the imports. It is difficult to see how it can be contended that it is to the advantages of American laborers to exchange the products of their toil for high priced goods from high wage countries rather than for low priced goods from low wage countries. The cheaper the goods are that are secured from abroad the greater is the advantage secured by the inhabitants of a given country from the exchange of goods with that country.

The Infant Industries Argument. — The most cogent argument offered in support of a protective tariff is the infant industries argument. It is to the effect that if the natural resources of a country and the capacity of the people are such that a given industry after it once gets under way could be maintained without protection against foreign competitors and against the other home industries that compete for labor and materials, then it is advisable to give protection while the industry is being developed. Under such conditions, the number of lines of industry can be increased and greater scope be given to the exercise of talent, without the disadvantage of a permanent reduction in prosperity which is the normal accompaniment of the protection of industry that cannot become self-supporting. But it must not be overlooked that this is an argument for temporary protection, not for a permanent policy of protective tariffs. The practical difficulty with such a program is, as will be emphasized presently, that after a tariff has been imposed it becomes very difficult to get it removed.

The classic exposition of the infant industries argument was made by Frederick List, a German writer, in a work published in 1841. His argument was that a nation in the natural course of events goes through successive stages of economic development, namely, the 1 agricultural, 2 agricultural-manufacturing, and the 3 agricultural-manufacturing-commercial stages. To assist a nation to pass from the agricultural stage to the one following it, argued List, it is advisable to give protection. During such a period the people will receive an industrial education, and will be able to enter the stage of fullest development without

the support of protective duties. Obviously, this argument cannot be used in support of a permanent policy of protection. It is applicable only to a nation that is developing into a manufacturing nation, and only during the period of that development.

The Favorable Balance of Trade Idea. — Another element in the support given to a policy of protection is found in the favorable balance of trade idea. If exports exceed imports the balance is said to be favorable, and if the opposite condition prevails it is said to be unfavorable. This is another expression of the common notion that it is well to sell but not advisable to buy. According to the everyday canons of conduct, to produce and sell and conserve the receipts is to follow the path to fortune, while to spend is to lay waste one's patrimony. The prevalence of this doctrine as a rule of individual conduct helps to explain the acceptance of protectionism, when it is phrased in terms of cutting down purchases from abroad, as this implies that the nation is buying less than formerly and presumably selling just as much. Hence the nation must be getting rich.

However, as was pointed out above, to reduce imports necessarily means that exports must also be curtailed. It is impossible to continue for long to sell abroad more than is purchased from abroad whether the balance is taken in money or in credit. Hence, it seems idle to approve of a protective tariff policy on the ground that an excess of exports over imports, of sales over purchases, will thereby be achieved.

There is so much said in current discussion relative to the importance of having a so-called favorable balance of trade that it is perhaps well to note that an excess of goods exports over goods imports may mean that any one of many different conditions prevails, or any combination of several different conditions. First, gold may be coming into the country in payment of the balance; second, foreigners may be selling bonds in the country, or to view the matter from the other side, persons and firms in the one country may be investing abroad; third, individuals and firms in the country in question may be paying interest on loans that they have earlier received from

foreigners; fourth, they may be engaged in paying the principal of such loans; fifth, merchants may be making payment for the freight service of foreign shipowners or, business men may be paying for insurance services, or residents may be sending money to friends and relatives in foreign countries, or persons in the one country may be spending considerable sums traveling abroad, or for still other reasons, persons in one country may be making remittances to persons in other countries.

In short, just as when a farmer, for example, sells a larger quantity of goods, measured in dollars, than he buys during a year the "balance" may be accounted for in innumerable ways, so sales of goods by the traders of a nation in excess of their purchases may mean that the balance is struck by the inclusion of any of the many items for which men dispose of goods. It would seem that with a "favorable" balance meaning so many different things there cannot be much point in thinking of it as favorable.

All Around Protection. — Many persons who advocate a policy of protection insist that they wish protection for all industries and not protection for favorite industries. The preceding analysis shows that it is impossible to have protection for all lines of work. Protection is necessarily discriminatory. It diverts the economic resources of a country into lines of activity that would not otherwise be followed, and thus away from the lines of work that would have been followed if the tariff had not been imposed. If it does not do this it fails to give *protection.* A protective policy is thus, as was explained above, a policy of discrimination against some industries and in favor of other industries. All around protection is thus an impossibility. One might as well expect to take money from the pockets of a dozen men and redistribute it to the advantage of each of the twelve, as to expect that a policy of protection could be of universal benefit. Some lines of work can be assisted only at the expense of other lines.

Growing Oranges in Ohio. — The preceding points may be illustrated by assuming that it is legally possible for the state

of Ohio to impose a tariff on imports, and that such a high duty is laid upon oranges that the importation of oranges into Ohio is so restricted that the price rises to such a point that it becomes profitable to construct hothouses and produce oranges within the state. This will "increase employment" in the hothouse and allied industries, and give employment in an entirely new kind of work, but, obviously, this will reduce employment in other lines of work. Goods that have been produced in preceding years and, in effect, exchanged with the people of California and Florida for oranges will not be produced. Exports will be reduced as a result of cutting down imports. Labor and materials will be transferred from lines of work that were formerly followed to the orange industry.

The prosperity of the state would be reduced as a result of this change in the direction of industry. Assuming that heretofore apples had been exchanged for oranges on the basis of a bushel of one for a crate of the other, and that the expenditure in labor, land, and materials now necessary to produce a crate of oranges formerly sufficed to produce two bushels of apples, it is clear that the total output of the state would be less than it formerly was. Each crate of oranges produced would mean the net loss of one bushel of apples. The well-being of the people of the state would be reduced. The wages of laborers measured in units of produce would be less than under the policy of free trade.

This is an extreme illustration. No protectionist would advocate the imposition of tariff duties in order to encourage the development of an industry so ill suited to the country as is the orange-growing industry to Ohio. The principle, however, is the same. The extreme case puts in bold relief the conditions that, although present, may not be clearly seen in the usual case. However well suited to a country an industry may be, the fact that it needs protection means that it is not so well suited as are the other home industries. For as already indicated, the need of protection means that a given industry cannot compete with the other home industries in hiring labor, borrowing money, renting land, and buying materials. If it

were equally well suited to the country, it could compete with the other industries in these respects, and thus would not need protection.

The Removal of Protection. — The above illustration is also applicable to another important phase of protectionism, namely, the effect of removing protective duties. To remove the duties on oranges in the situation assumed would bring considerable loss to the men who had invested in hothouse construction for the purpose of carrying on this industry. Likewise, persons who had become especially skilled in this line of work would suffer a loss of wages if protection were withdrawn. These considerations point to the conclusion that it is very disturbing to the industrial life of a country to discontinue a policy of protection, or indeed to change the rates of duties imposed. The industrial disturbance that thus tends to follow the removal, or the marked lowering of a tariff, would tend to be of relatively short duration. The fact that such a period of hard times followed a reduction in the tariff would be of no effect in determining whether given tariff rates are advisable in the long run.

The adverse effect of a reduction in a tariff duty makes it almost impossible to bring about a lowering of tariffs. The interests that would suffer from such a change in policy are normally able to exert considerable power in politics. Indeed, some of the protected industries normally become so formidable as the period of protection is continued that, except under very unusual conditions, it is possible for the persons representing such interests to exert sufficient pressure upon public opinion and lawmakers to prevent the abolition of the protective duties. The amount of money that certain protected interests in the United States could afford to spend in influencing elections and congressional legislation rather than have the tariff duties removed is colossal. No group less extensive than almost the entire population could afford to use any comparable sum in securing a removal of protective duties. Furthermore, of course, the protected group is well aware of its economic interests and conversant with the methods best calculated to secure it. This

is not true of the persons whose interests are adversely affected by a protective tariff.

PROBLEMS AND EXERCISES

22. "The foreign trade of Americans is essentially similar to the trade among the states, or the trade within a state." Is this sound? Discuss.

23. Name a group of producers in your state that suffers because of *free trade* between the citizens of that state and another state. If it were legally possible to *protect* these producers, is it reasonable to believe that they would ask for *protection?* Explain. Is it probable that they would be given *protection?* Explain.

24. "We spend thousands of dollars dredging harbors, laying cables, and building ships in order that we may trade with foreign nations and then we put up a tariff barrier and stop the trade we make possible." Does a tariff thus negative the benefits which accrue from improvements in transportation? Discuss.

25. Some men in the United States argue in support of a merchant marine and of a high protective tariff. Show that they are inconsistent.

26. "The tariff duties are really not levied against the foreign dye industry, but against the American steel industry, the oil industry, the automobile industry, the chemical industry, the railroads and other home industries." Discuss.

27. "If we buy rails from England, we get the rails, of course, but they get our money; while, if we buy rails at home, we have the rails and the money too." — A statement falsely credited to Lincoln.

(*a*) Is there any reason to expect that our buying rails in England would carry off our regular stock of money? Explain.

(*b*) Should we regret such trading because it decreases our stock of money, if that should result?

(*c*) Substitute "cotton" for "money" throughout the above quotation, and show the fallaciousness of the doctrine. (Taylor.)

Note: For a very interesting account of the history of this quotation which is credited to Lincoln see articles by F. W. Taussig in *The Quarterly Journal of Economics*, August, 1914, 28 : 814 and May, 1921, 35 : 500. These are reprinted in his book *Some Aspects of the Tariff Question.*

28. (*a*) "To the same extent that the home market is wrested from foreigners and given to protected home producers, the foreign market is wrested from unprotected home producers." — Seager, p. 418.

(*b*) "I believe in giving protection to every American producer." — Senator Smoot. Is Seager's point sound? Explain. Is tariff protection as contemplated in the second quotation possible? Discuss.

29. An English pamphlet of the Liberal party says: "One of the most absurd posters issued by the British advocates of a protective tariff, was one in which a British workingman was represented as saying: 'The foreigner has got my job!' That poster is a fraud. Rather we should say that it is the foreigner who provides jobs for British workingmen." Now, broadly speaking, neither of these statements is sound. The number of jobs — the amount of employment — would probably be substantially the same under protection as under free trade. The real advantage of free trade lies elsewhere.

(*a*) Support the contention of the next to the last sentence.

(*b*) What is "real advantage" referred to in the last sentence? (Taylor.)

30. "The protective tariff is responsible for the high wages that American workingmen receive."

(*a*) Argue that generally speaking this is not sound.

(*b*) How are the high wages to be accounted for?

(*c*) Argue that the sudden removal of protection would lower wages and create unemployment.

31. "The infant industries tariff argument presupposes that the tariff will be temporary, but experience shows that such tariffs tend to be maintained after the industry is fully grown." Account for this tendency.

32. (*a*) If all protective tariffs in this country were to be removed within the next year, what would be the probable immediate effects upon (1) prices; (2) employment; (3) wages? Explain.

(*b*) What would probably be the ultimate effects? Explain.

(*c*) What do your answers lead you to conclude as to the advisability of our abandoning the policy of protection, in whole or in part?

CHAPTER XXXV

FOREIGN TRADE POLICY (*Continued*)

Nationalism and Protection. — In the preceding chapter attention was directed in part to an explanation of the reason for the prevailing policy of protection. Unquestionably, the spirit of nationalism is an important factor in promoting this policy. An individual identifies himself with the groups of which he is a member. This group consciousness in part takes the form of opposition to, and defense against, other groups. One of its most important manifestations is in relation to national groups. Emphasis upon national traditions and, especially, upon the history of warfare among nations, greatly increases this spirit of antagonism among the people of different nations. This encourages the adoption of a policy of protection. For with every foreigner a potential enemy, at least, it is not difficult to secure support for a policy that is phrased in terms of "protecting" fellow citizens against foreigners, especially if the disadvantages that accompany such a policy are not clearly appreciated.

The Military Argument. — It is often urged in favor of a protective tariff that the industries of a nation are thereby diversified, and that as a result the nation will be stronger in time of war than if a policy of free trade had been followed, particularly because it will be better able to withstand the severance of commercial relations that normally accompanies a period of war. This argument is valid, but it carries the implication that protective tariffs are, like costly armaments, the price of living in a warring world, and not to be justified on the basis of their effect upon economic well-being.

Protection by Means of Bounties. — The government may protect an industry against its foreign competitors by giving a cash bounty to the producers of the article in question. This

has been done in the United States for short periods of time in the case of sugar. So far as protection is concerned the bounty is the same as a tariff duty. If sugar producers, for example, are given a bounty of two cents per pound for the sugar they produce, they are in the same position that they would be in if a tariff rate of two cents per pound permitted them to increase the price of their sugar by this amount.

The burden of protection is different, however, in the two cases. Under a protective tariff the cost of furnishing protection falls upon the consumers of the article in question, while in case a bounty is paid the expense of protection is borne by the taxpayers of the nation. The demands of justice point toward the advisability of furnishing protection by bounties derived by taxation, rather than by extra costs in the shape of higher prices being imposed upon consumers, since the argument in justification of protection is that a benefit will be derived by the nation as a whole. If it were claimed that the consumers of a given article benefit by having to buy at a high price from home producers rather than at a low price from foreign producers, it would seem to be preferable to have the cost for protection rest upon the consumers. But since the benefit is held to accrue to the nation as a whole, it would seem to be proper to pay for protection in taxes.

But despite the advisability of using bounties if protection is to be given, they are very unpopular and are seldom used. The principal reason for this is undoubtedly that in such a case it is very evident that the protection that is accorded to the favored industry represents a cost to the general public. This is not apparent if tariff duties are used. Indeed, as already suggested, the arguments in favor of protection imply that protection is not only costless but highly beneficial to the general public.

Tariff for Revenue. — Tariff duties may be used to secure revenue for governments as well as to protect certain home industries against foreign competition. Sometimes governments wish to use tariff duties as a means of securing revenue, but do not wish to give protection to any home industry. There are

at least three ways by which this may be done. First, those articles that are imported but that cannot be produced in the country may be subjected to a duty. For example, a duty is imposed upon tea and coffee that are imported into the United States, but this does not give protection to home industry as neither tea nor coffee can be produced here. There might, of course, be a case of industries that are so closely related to one that is subjected to a revenue duty, that they would receive protection as a result of the rise in the price of the one article. But in general a tariff upon a good that is not produced in a given country is considered as being levied solely for purposes of revenue.

A second method of providing revenue through the imposition of a tariff, without affording protection, is to levy a tax upon the home production of the article in question equal to the tariff duty. This has long been the practice in England. In addition to placing duties upon a few goods that cannot be produced within the country, the English government has levied duties upon such goods as spirituous liquors and has imposed a tax equal in amount upon such goods when they are produced within the country. This arrangement means, of course, that the fact that an importer of such goods has to pay an import duty does not give home producers any protection. The tax that they have to pay puts them in the same position relative to the importer that they would have been in if the tariff had not been imposed.

In the third place the production of a good that is subject to an import duty may be prohibited, as is done in England in the case of tobacco. The tariff in such a case cannot protect the home industry.

A tariff duty will give both revenue and protection if it is levied upon an article that is produced at home, and is not so high as to prohibit importation, assuming that there are no special provisions made to offset the protective effect of the duty such as have just been indicated. Most of the duties in the tariff laws of the United States are of that nature. But, of course, to the extent that revenue is derived, protection is not

obtained. That is, the largest degree of protection results when no foreign goods are imported. A duty high enough to give such protection — to prevent importation — would of course not yield any revenue, but usually duties are not sufficiently high to exclude entirely foreign merchandise, and are high enough to force the price above what it would otherwise be. Thus some revenue is secured and some protection is extended.

To illustrate, assume that the demand for a certain article in the United States is such that one million units can be sold each year at a price of one dollar. Assume also that foreign traders can sell this article in American markets at ninety cents per unit, while American producers must receive at least ninety-five cents per unit in order to engage in this line of work. If under these conditions, a tariff of ten cents per unit is levied, it will be necessary for the foreign traders to charge one dollar per unit. American producers will thus be able, under the protection of this duty, to engage in this kind of industry. If the home producers do not supply the entire one million units per year, that is, if there is any importation, then, clearly, both revenue and protection result. If, for example, seven hundred thousand units are produced at home and three hundred thousand imported, revenue will be secured upon the latter number, while the protective effect of the tariff makes possible the production of the former number within the country.

Revenue and Cost to the Consumer. — The above illustration shows that whenever protection is secured the revenue which is derived by the government is not equal to the extra expense that is imposed upon consumers. In the above illustration, assuming that the one million units could have been purchased otherwise at ninety cents, the extra cost to the consumers because of the tariff is one hundred thousand dollars, but the receipts to the government amount to only thirty thousand dollars.

It is possible that the foreign producers in the case cited could not have supplied the entire one million units at a price of ninety cents. To secure this larger volume, it would then have been necessary for American buyers to bid the price above this point.

In other words, the selling price of one dollar for one million units would not then, under this assumption, mean an extra cost of ten cents per unit. Just what the situation would be in any case could be determined, if at all, only as a result of a very careful investigation, but the cost to the consumer is always in excess of the revenue derived whenever any protection is afforded. Hence, as a substitute for taxes, a tariff that gives protection costs the people of a nation more as consumers than it saves them as taxpayers. The extra cost is the price paid for protection. If there is no extra cost, there is no protection, and the tariff duty is of no avail as a means of protecting home industry.

Tariff Receipts as Government Revenue. — The place of tariff receipts in the revenue system of the government will be discussed later in connection with the subject of the government finances. It is well, however, to note in this place that tariff receipts have not proved to be a desirable form of revenue to the United States government. Tariff receipts vary greatly from year to year, thus when they are relied on as a source of income they tend to lead to alternate periods of surplus and deficit. In the earlier years of our national history, the tariff was at times the sole source of national income. During this period the fiscal officers were occasionally embarrassed by having insufficient funds to meet government expenses, and at other times Congress indulged in extravagances because of the available surplus. At the present time the tariff duties are less prominent in the national budget than they have been heretofore. This has come not from a change in tariff policy, but because of the enormous increase in government expenses, and the resort to taxes as a means of providing the revenue for the expanded budget. This, of course, means that the tariff receipts are less unsatisfactory as a source of revenue than when they constituted the sole, or the major source of the national revenue.

"Protection" that Does Not Protect. — Quite obviously, to make legal provision for the imposition of duties upon certain imports does not necessarily give protection to the home producers of such goods. Protection is given only if foreign goods

that would otherwise come in are kept out, or are allowed to come in only at an increased price. That is, if any article is not imported, if home producers supply the market exclusively, then a tariff duty could not give protection. Most agricultural products, for example, could not be produced abroad and sold in our markets in competition with our domestic products, if there were no tariff duties at all. Hence our home producers of such goods cannot be protected by a tariff. But in our present tariff law, the Fordney-McCumber Act of 1920, pork and many other articles that foreign producers could not afford to sell in our markets are solemnly specified as being subject to a tariff duty if imported.

There has been considerable controversy regarding the effect of a tariff on wheat. In the absence of a tariff duty, a considerable quantity of wheat has come into the United States from Canada, but under the present tariff restrictions but little wheat is imported. This, however, does not prove that the exclusion of Canadian wheat permits American farmers to get higher prices than if Canadian wheat were imported. In general, the situation is as follows: Wheat is sold in a world market. The price in Chicago and Minneapolis is closely related to the price in Liverpool, where a large quantity of our wheat is sold. A low price in Liverpool means a low price in Chicago and a high price there will force the price up here. Thus the farmers in the United States must meet the competition of Canadian wheat so long as wheat is exported from this country. If Canadian wheat is sold in Minneapolis, less wheat is sent from Canada to Liverpool, and more wheat from our farms is sold abroad. This being true, the price in our markets tends to be the same whether Canadian wheat is sold in Minneapolis or Liverpool. Our farmers cannot escape the competition of a world market.

The above analysis is based on the assumption that wheat is all of one grade. This is not the case. The Canadian wheat is of such a quality that it is very superior as a blend in the manufacture of high grade flour. The wheat of Minnesota and the Dakotas is of the same quality as the Canadian wheat. The local market is sufficient to take all of the home grown wheat

of this grade and some of the Canadian wheat by importation. To force up the price of the Canadian wheat in our market by the imposition of a tariff duty thus permits the home growers of this grade of wheat to receive a higher price than they would otherwise be able to get. This is an ordinary case of protection. This grade of wheat is, in effect, a commodity that without protection must be sold in the home market in competition with wheat from abroad.

Further, of course, if there are districts in the Northwest in which some wheat is grown, but not a sufficient quantity to meet the local needs, the tariff on Canadian wheat is to the advantage of the wheat growers in those districts. If the Canadian wheat can be kept out of such regions, wheat must be shipped from the central districts and the local price must be sufficient to cover transportation costs from the shipping point. Local growers under such conditions will get a price equal to the price in the central market, plus the cost of transportation. They will be protected by the amount of the transportation cost, if they can be protected from the Canadian wheat which is just across the border. This, too, is an ordinary case of protection against competition in the home market. Whether such protection is desirable is, of course, another question.

The Tariff and Dumping. — The practice of selling goods in the home market at a given price and selling goods of the same kind at a lower price abroad is known as dumping. Because of the large element of fixed expense in its cost of production, a firm may easily find it to its advantage to sell part of its product at a lower price abroad than it could afford to take for the entire output. This point was discussed in the chapters on price. The illustration from the experience of Edison is in point here. Since his plant was so large that he did not have a market in America for all the lamps that he might have produced, he found it possible to augment his output by 25 per cent while increasing his total cost of production by only 2 per cent. Thus it was profitable for him to produce this extra amount, 25 per cent of the total, so long as he recovered more than the extra cost, 2 per cent of the total. To have set a price so as to have

disposed of the entire output in America would have led him into bankruptcy. Accordingly, Edison followed the plan of maintaining the customary price in America and dumping the extra product abroad. He instructed his agents to quote an especially low price to foreign dealers, in order that he might have a market for this extra supply.

It is obvious that such a selling program on the part of Edison would tend to force European firms into bankruptcy. If these especially low prices were to be continued by Edison, his selling abroad would be to the advantage of the consuming public abroad, even though it caused considerable loss to the firms that had been engaged in the manufacture of lamps. But in such a case, the danger to the consuming public is that if the home producers have been driven out of business, the foreign seller will increase his price. It is this practice among dealers that has made the process of dumping especially objectionable. Tariff laws accordingly often make special provision to guard against dumping. Our present law provides that in case a foreign product is being sold in the United States at less than its "fair value," a special duty equal to the difference between the foreign price and the price in the American market shall be imposed by order of the President. And in case of flagrant conditions of this kind the President has power to forbid entirely the importation of such merchandise.

Kinds of Tariff Duties. — Tariff duties are of two kinds, *specific* and *ad valorem*. A specific duty is one that is levied according to physical measurement, as so much per pound, or per yard. An ad valorem duty, as the term suggests, is one that is levied upon merchandise according to its value. Such a duty is expressed in terms of percentages. In the case of some articles both a specific and an ad valorem duty are imposed.

The Method of Tariff Legislation. — A tariff bill is a very complicated affair. It covers a vast number of articles, many of which are subdivided into many different grades. Further, many of the articles or groups of articles are so highly technical in character that only experts can distinguish among them or know the uses to which they are put. Congressmen must for

this reason rely largely on experts in forming judgments as to the desirable rates of duty. Such experts are usually connected with industries that desire to be protected. To the extent that this is true, duties are not determined by the unbiased judgment of disinterested persons but represent the desires of particular interests.

Closely connected with this is the maintenance of expert lobbyists at Washington by the groups that desire protection. The possible profit which certain industries would realize if high tariff duties were levied, or the loss that would follow the scaling down of existing duties, prompts the men in those industries to engage the shrewdest possible talent to assist them in convincing the legislators that given lines of tariff policy are desirable.

The self-interest of the groups desiring protection also appears in the activity of the legislators themselves. The representatives or senators who desire protection for industries in their districts or states offer to support other industries in return for votes in favor of the duties they desire. Such trading or logrolling is very pronounced in the passage of a tariff bill. As Senator Knute Nelson, who was for many years a supporter of the protective tariff, said, during the debate on the Payne-Aldrich Tariff Act (1909), "a tariff bill is not framed on the basis of patriotism. It is a question of 'you tickle me and I'll tickle you.' You vote to protect the things from my state and I'll vote to protect the things from your state." This leads, of course, to the levying of higher duties, and to the inclusion of more articles on the tariff list, than would otherwise be the case.

Tariff History. — The imposition of a tariff duty began very soon after the inauguration of our national government. Indeed, during the colonial days, the colonies levied import duties against each other (and occasionally also export duties) and thus when the nation was formed, the use of protective tariff duties was not a new departure. There was, however, a marked difference in the situation of the national government as compared with that in colonial days. The larger national territory gave more emphasis to the conflict of interest that is involved in

tariff legislation, than did protection in the separate colonies. The prominent business men in one section who desired protection for their products in the national market found themselves opposed by equally powerful business men who were purchasers of the product in question. Thus began the long sectional controversy over the protective tariff question which has not yet ended. Indeed, throughout the entire tariff history of the United States the dominant note has been the selfish struggle of different groups against each other. This could not well be otherwise if each group is aware of its interest, for, as discussed above, protection is necessarily a discrimination in favor of certain persons and against other persons within the nation.

One of the first significant dates in our tariff history is 1792, the year in which Alexander Hamilton made his celebrated *Report on Manufactures*. In this report he argued strongly that protection should be adopted to encourage the development of manufacturing. His advice was followed and tariff duties were imposed. During the War of 1812–1814 and in the period immediately preceding, the importation of foreign goods ceased almost entirely and American manufacture increased rapidly under this effective form of protection. At the conclusion of the war men who had built up manufacturing industries insisted that protection should be provided for them against the foreign competition which they anticipated that they would then have to face. They were successful in their demands and the policy of high protection was inaugurated.

Another important period in tariff history is that of the Civil War. During this time tariff duties were considerably increased so as to provide additional revenue for the conduct of the war. And in order that home producers might not profit unduly as a result of the consumers thus being burdened with higher prices in order that government revenue might be obtained, it was provided that taxes equal to the new duties should be paid by the manufacturers in the various lines that were concerned. The taxes, too, of course, were a source of revenue to the government. Thus the policy of tariff for revenue without protection was followed.

It was confidently expected that at the close of the war both the special tariff duties and the corresponding taxes would be repealed. This, however, was not done. The taxes were removed, but the interests in question were able to prevail upon Congress not to repeal the tariff duties, and they became from that time on the standard rates of duties in our tariff system. That is, the high tariff provisions which were inaugurated during the Civil War have continued until the present time. All during this period the manufacturing interests have been dominant in our social and political system. They have, speaking broadly, controlled public opinion. Our magazines, newspapers, and politicians have been largely under their influence. The leaders of this group have been men of great force of personality. As compared with them the men of the agricultural group, the group most adversely affected by tariff regulations, have been impotent. Indeed, the farmers as a whole have accepted the conclusions of the manufacturers that the tariff is to the farmers' advantage. The nation as a whole has thus been strongly favorable to a policy of protection. The question at issue has been in regard to the height of the duties rather than as to the desirability of removing them entirely.

The tariff question was very prominent in the political campaigns of the eighties and the early nineties, with alternate periods of victory for the high tariff and the low tariff advocates. In 1896 the political contest was concerned with the question of bimetallism versus monometallism, but following the inauguration of McKinley in March, 1897, Congress was called in special session to consider a revision of the tariff duties which had been established by the low tariff party in 1894. The Dingley tariff bill was promptly passed. It raised the tariff duties to the highest point that had yet been reached.

The years following the passage of the Dingley Act were marked by a great growth in the scale of business operations and by the formation of a large number of trusts or business combinations. The opponents of the trust movement pointed to the protective tariff as the factor which was chiefly responsible for them. A prominent sugar magnate of this period gave added

strength to this contention by saying before a congressional committee, "The tariff is the mother of trusts." The argument was that the tariff prevented foreign competition and thus made it possible for American producers to form monopolies and extort high prices, and also that the tariff made the production at home so lucrative that plants had been built so much beyond the capacity of the market to absorb their output that cut-throat competition had led to the consolidation of the different plants. Thus it was contended that the tariff rates should be reduced in order to check the growth of monopolistic combinations.

In 1908, the Republicans under Taft's leadership promised "tariff revision" if they should win the election. They were successful in their campaign, but the resulting tariff law, the Payne-Aldrich act of 1909, provided for even higher duties than had prevailed. This was, perhaps, the dominant factor that led to the disruption of the Republican party and the election of Wilson in 1912. The Underwood tariff was then enacted in 1913. It established lower duty on many products and placed many articles upon the free list. The Republicans came into power again in 1921 and enacted the Fordney-McCumber tariff law which provides the highest tariff rates in our history.

The Tariff Commission. — One comparatively recent feature of our tariff policy has been the creation of a tariff commission charged with the duty of conducting investigations pertaining to our tariff policy. One important feature of the work of this commission has been the conduct of investigations relative to the cost of producing certain goods at home and abroad with a view to determining the rate of duty that will afford protection. It is expected, of course, that the findings of the commission will be used by Congress in the enactment of subsequent tariff legislation.

It is well to note that it is very difficult, if not impossible, to secure reliable cost data in regard to the production of most articles of commerce. Foreign producers are under no obligation to furnish data as to their costs. But even if they would offer full coöperation, the task would remain a difficult one. Cost

data are not accurately kept and classified by all producers and where this is done the methods of cost accounting may differ so greatly, especially in plants located in different countries, that comparisons are almost useless. But, however limited are the data, it is reasonable to believe that they may be of some value in the shaping of legislation.

Some persons have expressed the hope that the tariff commission might point the way to the construction of a "scientific" tariff law. Another phrasing for this is that, as a result of the work of the commission, the tariff might cease to be a "football of politics." The very nature of a protective tariff, however, makes it impossible to remove it from politics. It is a device whereby certain groups through legislation gain an economic advantage over other groups. This makes the question of protection essentially a question of politics. One might as well expect that the question of taxation should cease to be a question of politics, as that the question of protection could be removed from this field.

The Elastic Provisions of the McCumber-Fordney Act. — The McCumber-Fordney Act of 1921 contained what came to be called elastic provisions for tariff duties. The President was given power to alter tariff rates on individual articles within prescribed limits, either upward or downward, if the findings of the tariff commission warranted such changes. The principal reason for the inclusion of this provision was that the prices which prevailed at that time, especially the prices in certain European countries, were not regarded as permanent, and it was felt that price changes subsequent to the tariff act might make it desirable to alter certain tariff duties. Rather than have such alterations wait upon the action of Congress, Congress provided that the President might within limits alter the duties which it had prescribed. This provision was heralded as a great improvement in our tariff legislation.

The practice under this provision has not, however, justified the enthusiasm of its sponsors. President Coolidge, who is a stanch protectionist, has followed the recommendations of the commission when they have called for an increase in tariff duties

and has, almost without exception, not followed the recommendations when they have called for the reduction of a tariff duty. If the elastic provisions are retained in our future tariff laws, the experience under other presidents may be different, but it seems reasonable to conclude that this delegation of legislative power by Congress will contribute but little to an improved tariff policy.

Trends in American Foreign Trade Relations. — Certain significant changes have come about recently in our foreign trade relations that may eventually lead to a change in our long continued policy of high protection. First, the character of our exports and imports differs greatly as compared with those which formerly prevailed. Throughout our history, our leading exports have been foodstuffs and raw materials, and our imports have been manufactured goods. This led logically to a policy of protection. The manufacturers, always an influential group, have desired protection. The exporters of foodstuffs and raw materials have been largely unorganized and ineffective in respect to tariff legislation. Further, the desire for such products abroad has been such that foreign countries have not retaliated against our high tariff policy by levying duties upon such goods.

But within the past few decades the volume of our exports of manufactured goods has greatly increased, both absolutely and relatively, and the proportion of foodstuffs and raw materials in our total exports has declined markedly. Sales abroad of manufactured goods mean, generally, an ability to compete in foreign markets. To some extent, these sales may represent "dumping," and not ability to compete in an open market. But as such sales are extended they tend to indicate that the manufacturers concerned do not need protection in the home market. This is clearly the case in the automobile industry. This condition alone would not cause manufacturers to ask for an abandonment of protection. But tariffs levied by us tend to prompt other nations to retaliate. Such retaliatory tariffs may prevent an American manufacturer from selling in a country in which he has built up a market at considerable expense. Thus in 1920,

representatives of automobile manufacturers requested Congress to reduce the tariff on automobiles, and gave as one reason, that retaliatory tariffs against American automobiles were less likely if we had low duties.

Further, manufacturers are keen enough to see that sales abroad are conditioned upon purchases from abroad, and for this reason they favor a low tariff, or a free trade, policy if they are anxious to build up foreign markets. The conclusion thus seems to be warranted that the extension of export trade in manufactures will tend to cause us to move toward a low tariff policy.

The second significant change in our foreign trade relations has been indicated in another connection. We have become a creditor nation since the beginning of the World War, whereas until that time we had always been a debtor nation. A debtor nation must pay the interest and the principal charges upon the debts which its citizens owe abroad by exporting more than is imported. But a creditor nation must import more than it exports in order to receive payment for loans extended. The extensive loans which the people of this nation, and the government, have made abroad thus point toward a policy which will encourage the importation of goods. Such a change in policy may not come about for many years, but it can hardly be prevented if foreign loans continue to be made.

Foreign Trade and War. — Many persons believe that the principal cause of war is found in foreign trade. The struggle for markets, we are told, leads to war. It is argued that each of the contending national groups hopes to be able to dominate the market in question after the war. There is perhaps some merit to this argument, but it may easily be pushed too far. Commercial rivalry in a foreign locality among small groups of persons from different nations may easily promote ill feeling among these groups. The reports which such persons make in their home countries may deepen the animosity toward foreigners that seems to be latent in all peoples, and thus increase the possibility of war. But it is perhaps only in this indirect way that the "struggle for markets" leads to war.

On the other hand it is argued that the development of trade relations makes the people of the different nations dependent on each other and thus makes them reluctant to go to war. One aspect of this is the financial interests that come to be involved as a result of persons' loaning money in foreign countries. Such relationships make for peace.

To consider further the factors in international trade relations that make for war, many persons see in the problem of concessions to mineral or oil lands in the so-called backward countries a potent cause of war. If a small group of persons from one nation has secured concessions of this sort, and if persons from another nation should later wish to have the concessions transferred to them, they may seek to accomplish this through embroiling their home country in a war. One line of procedure, in such a case, is to set up a rival claim and get support for this claim from a revolutionary group in the local country. The next step is to ask the home country to protect the property rights of its citizens. Disturbances are then likely to occur, and property may be damaged and lives of citizens of the home country may be lost. The home flag may be insulted, too. Such occurrences, which may be deliberately fostered by the concessionaries, may be skillfully used in the home country in fanning the flames of war. The "concessionary interests" often control newspapers, and have the ear of the officials in the foreign office of the home government. This greatly increases their power to influence national conduct and to bring about war, if they believe that war is desirable from the point of view of their interests.

The terminology that is usually employed in such cases tends to foster the spirit of war. Instead of speaking of the property rights that are involved as belonging to Mr. X, or corporation Y, they are spoken of as if they belonged to all of the people of the nation. If the concessionary is a German, he talks not in terms of his property, but of German property; if an American, he emphasizes the desirability of the United States government's protecting *its* property. Such phrasing gives a very unreal picture. It identifies the interest of the concessionary

with the interest of his nation, but as will be further emphasized presently, there may be but little, or no, relation between gain to the concessionary and gain to the people of the home nation. If the terminology that correctly describes the situation were used, the people of the home country would normally be but little concerned about the matter.

Economic Gain from Conquest. — The unfortunate phrasing to which reference has just been made, serves also to becloud the issues relative to the effect of conquest on the economic welfare of the people of a nation. The Germans — or Germany — we are told profited greatly by the conquest of Alsace-Lorraine in 1870. The iron and coal of this region, it is said, made it possible for German industries to prosper from 1870 up to the time of the World War. The implication is that the iron and coal could not have been thus used if the German nation had not had possession of this territory. This statement is largely invalid. The error comes from thinking of privately owned property as if it were owned by the nation as a whole.

When the Germans took Alsace-Lorraine the rights of individual property owners in this region were not confiscated to the German government. The same persons held the rights to the iron and coal mines after the German flag was hoisted who had held them when the French flag had been over them. The products of the mines, after the conquest as before, were presumably sold to the highest bidder regardless of his nationality. If German manufacturers used the minerals, they did so because they could outbid the French and other competitors. Presumably the fact of national control made no difference. Of course, if before the conquest, the Germans had sought to exclude these minerals by the erection of a protective tariff barrier, and if after 1870, the French had levied tariffs against their import, the fact of national control would have altered the situation. But that would have meant that conquest gave to the Germans the benefit of free trade which they might have had by not imposing a tariff; and it would have meant that by levying the tariff, and not as a direct result of the German conquest, the remainder of France lost the economic advantage

that it had enjoyed as a consequence of free trade with Alsace-Lorraine.

This conquest by the Germans did strengthen the nation as a nation. It gave more soldiers and more minerals for war. But this was a nationalistic — a militaristic — gain, not an economic gain to the average citizen of Germany.

Similarly, the inclusion of the southern provinces of Canada in the United States would not result in economic gain to the average citizen in what is now the United States, except as such inclusion would result in free trade that is now prevented by protective tariff barriers. And likewise, the loss from the nation of any section of the Union would not result in economic loss to the inhabitants of the remainder of the country, if free trade were continued.

Slight reservations need to be made to the above argument. Trade does follow the flag to some extent. Government officials, temporary residents, and travelers, from the home country, result in some extension of trade by the producers of export goods in the home country. But such gains to the people generally tend to be of the order of minor magnitudes. Trade does not depend on the absence of political boundaries as is clearly shown by the very extensive trade among the peoples of the leading nations. The English, German, and French people, for example, profit greatly from trade relations with each other. They would profit still more if tariff barriers could be removed, but this does not need to wait upon conquest.

The economic relations among the peoples of these three political divisions are similar to those that prevail among the different sections of the United States. Trade relations are to the mutual advantage of the people of the different localities, and this is secured without any reference to state lines.

Gains to individuals as contrasted with gains to the people as a whole may be further illustrated by reference to Porto Rico. This island has been controlled by the United States government since it was taken from Spain by conquest in 1898. The principal product of the island is sugar, all of which is sent to the States. This is usually described by American writers as

"our" sugar. By controlling Porto Rico we have a source of supply of this important food, we are told. It is true, of course, that sugar is essential to our present standard of living, but political control over sugar fields is not necessary in order to have it. We could get much more sugar from Cuba than we do get if we would remove the tariff on sugar. The gain to Americans from control over Porto Rico, so far as sugar is concerned, accrues to individual Americans who own sugar plantations there, and have a tariff advantage over Cuban producers in the home market. These sugar plantations are "ours" when we think in national terms, but when "we" come to buy this sugar it develops that it is owned by private individuals who get as much per pound for it as they possibly can. If Porto Rico were controlled by some other country, or were independent, and if the sugar produced there were admitted free of duty, the situation would be the same as prevails now, unless the very unusual step was taken of prohibiting the export of sugar to us.

Still another reservation needs to be made in this connection. If conquest results in a more orderly government — in a more orderly economic life — the citizens generally in the home country may profit thereby, as the total output of the economic goods of the world would be increased. The gains from this would go, however, to the people of the world generally and not to the inhabitants of the conquering country.

PROBLEMS AND EXERCISES

33. "Though injurious economically, a protective tariff may be justifiable politically if there is sufficient likelihood of war."

(*a*) Give the supporting argument. (*b*) Cite historic illustrations in support of this position.

34. What is a tariff for revenue only? A tariff for protection? What general class of goods would bear a duty in the one case? In the other?

35. "A reduction of $60,000,000 in tariff duties means a reduction in the burden upon the people's consumption of approximately $600,000,000." — Senator Newlands, in *The Independent*, 73:757. Explain.

36. Argue that it is on the whole better to pay a bounty from the

proceeds of taxation to producers whom we wish to encourage than to impose a tariff.

37. Show that a protective tariff is tantamount (similar) to a subsidy paid to certain producers from the proceeds of taxation.

38. (*a*) "Protective tariffs constitute one of the leading accessory causes of war." (*b*) "Free trade cannot but make for international amity." Evaluate the above statements and defend briefly your evaluation.

38. Militarists often argue that a policy of tariff protection will diversify a nation's industries and make that nation self-sufficient.

(*a*) Is there a single country for which this statement is wholly valid? (*b*) What does this argument presume with regard to any given country's powers of productivity?

40. Is a newspaper consistent if it favors the payment of the French debt to the United States and opposes the removal of the high American protective duties? Why?

41. Which of the following would you expect to favor protection? To oppose it? Why?

Wheat farmers; wool raisers; international bankers; dyestuff manufacturers; automobile manufacturers.

42. (1) Draw up a supply and demand schedule for a kind of aluminum in the United States market under free trade. Assume that one-third of the supply is imported. (2) Alter the schedule to show the effect of a 25 per cent ad valorem duty on this product.

43. "As a nation advances to the industrial stage that makes it an exporter of manufactured articles, the manufacturers tend to become advocates of free trade." Why? Do they.

44. The representatives of the National Automobile Chamber of Commerce suggested before the House Ways and Means Committee in December, 1920, that the duty on high-priced foreign cars be reduced from 45 per cent to 30 per cent. They argued (1) that government revenue would be increased; (2) that foreign discrimination against American automobiles would be less likely; and (3) that foreign industry would be assisted in reviving. Which of these arguments is the most significant as showing a tendency for an alteration in our tariff policy? Explain. Are the three arguments sound? Explain.

45. "No wonder the American farmer is nearly bankrupt. Everything he buys he purchases at an artificial, protected price. The price of everything he sells is fixed in the world market." Is this statement true or false? Explain.

46. "Europe is mortgaged to America," one publicist has said in speaking of the billions of dollars of foreign claims that we have. Is it likely that this will have any bearing upon our future tariff policy? Why?

47. Political scientists who oppose geographical representation, such as prevails with us, do so upon the grounds that interests of a geographical district vary and that in the federal legislature, the legislators with the same economic interests are bound together regardless of the geographical districts they represent. Illustrate this point of view from observations on tariff legislation.

48. "Europe's economic salvation lies in the breaking down of her internal trade barriers." "The economic progress of the United States is due, among other things, to the fact that they comprise the largest developed free trade area in the world."

(*a*) What is to be said of the truth of these two statements? (*b*) Is the same principle expressed in each statement?

REFERENCES

F. W. Taussig of Harvard University is one of the leading authorities on the subject of the protective tariff. His *Principles of Economics* may be consulted with profit and also his *Some Aspects of the Tariff Question*, 1915; *Tariff History of the United States*, 7th ed., 1923; and *International Trade*, 1927. All of the standard texts in economics discuss the subject, and the economic journals carry occasional articles that deal with it. See appendix.

For a discussion of the effect of political conquest on economic gain see *The Great Illusion*, by Norman Angel, 1913.

PART VII

SOME CASES OF SOCIAL CONTROL

CHAPTER XXXVI

SOCIAL CONTROL AND PUBLIC UTILITIES

I. Social Control

Our Economic Society. — As stated in the early portion of Volume I of this book, and as emphasized in later chapters, our society is based predominantly on the principle of private property, or individual initiative. But it is not a system without control. The principle of *laissez faire* is frequently extolled in public discussion, but at no time has *laissez faire* really prevailed. Our society has never been one of anarchism. Government control has always been an important factor in our economic life, and this is more true of the society to-day than it has been in the past. The marked increase in the degree of economic interdependence during the past several decades has necessarily meant an increase in the degree of government control.

Not only have we had, and do we have, a large measure of government control by the various local, state, and national governments over our economic relationships — which is the negation of anarchism — but there has also always been a considerable measure of non-government control by the various groups in our economic society. This control may be said to be autonomous, or self-imposed, or voluntary, in contrast to the control that is exercised by the political governments. Associations of business men, monopolies formed by the combination of business units, and the organization of laborers into trade unions are all illustrative of this second form of control over the economic activity of individuals.

Political control in a democracy such as ours is also self-imposed, and voluntary, and our major political units have autonomous power, but clearly so far as coal mine operators, for example, are concerned, the provision by a state legislature

that miners may not work below ground for more than eight hours per day is in sharp contrast to a similar provision that might be agreed upon voluntarily by the mine operators in another state. In the first case the provision is mandatory. The other citizens, through the state legislature, impose it upon the mine operators. But in the second case the restriction is voluntarily assumed by the mine operators. Social control over the economic conduct of individuals may thus be analyzed into two forms: government control and group control.

It is frequently suggested that the forces of our economic life are not subject to control. The argument or implication is that they are natural, God-given, immutable. It is said, for example, that the law of supply and demand cannot be repealed; that certain prices are natural prices and only they can prevail; that men always respond in a certain way to economic considerations. This is unsound as has been emphasized above, especially in Chapter V. The supply of goods and of labor service can be controlled within limits by the sellers thereof. Certain prices are thus not inevitable. Further, the responses of men are largely the result of their social environment. Hence, a human society, and, thus, the economic part of a human society, can be made into what its members desire. This does not mean, of course, that figs may be grown of thistles nor that men may be given immortality, but that within the bounds of physical limitations the social arrangements may be made as we will. Predispositions due to the circumstances of life may make it impossible at any one time to effect certain arrangements, but this is not to say that such arrangements could not be made if the people desired them. Perhaps every conceivable form of social institution has prevailed at some time in some society. Certainly, a large number of different methods of social organization, including, of course, the organization of the economic aspect of life, have been authentically recorded. We do seem to be able, collectively, to determine that which we will have. Hence, one of the tasks of citizenship is so to control the economic forces that our society in this respect will become what we would like it to be.

The above discussion is in part a repetition of that which has appeared earlier. The subject of social control was discussed in a general way in Chapter II and, in Chapter V, as just indicated. Almost all of the special topics that have been considered have either involved, or directly concerned, the question of control. The corporation, for example, is a creature of the government, and all of its activity is limited by law. The problems of money and banking are largely those of the regulations that should be imposed upon these devices which men have created to facilitate exchange. Protection versus free trade is essentially the question of control versus freedom so far as international trade is concerned. In the subject of prices, the question of control or lack of it by buyers and sellers is involved. Other illustrations could be added, but these are sufficient to indicate that the question of control is a dominant one in the consideration of many phases of our economic affairs. Hence, the present division of this book does not differ from the preceding portions in respect to the problem of social control. This division consists merely of a group of subjects that merit discussion, and that might logically have been included with the other divisions, but in order that other topics might be discussed early in the book, the consideration of these subjects was postponed until this time.

II. Political Control in Respect to Monopolies

Grants of Monopoly by Queen Elizabeth. — The reason for the formation of monopolies has already been made clear in the chapter dealing with monopoly price, and in the discussion of competition in Chapter II. Men desire to have monopolies in order to eliminate or reduce competition, and thus enjoy higher prices than would otherwise prevail. During the reign of Elizabeth, the last of the Tudors, many monopolies were granted by the royal power. These included trading monopolies, such as the East India Company, chartered in 1600, and grants to favored individuals of monopolies in the production and sale of currants, salt, iron, powder, playing cards, calfskins, hides, potash, vinegar, coal, steel, aqua vitae, brushes, bottles,

saltpeter, lead, oil, glass, paper, starch, sulphur, and new drapery.[1] But there were strong objections to this policy. Protests in Parliament led to the revocation of some of these grants, and in 1602 an English court, in the case of Darcy *v.* Allen, declared unlawful the grant of a monopoly to manufacture playing cards. The court held that, "All trades, as well mechanical as others, which prevent idleness (the bane of the Commonwealth) and exercise men and youth in labor for the maintenance of themselves and their families, and for the increase in their substance to serve the Queen when occasion shall require, are profitable for the Commonwealth; and therefore the grant to the plaintiff is against the common law and the benefit and the liberty of the subject."[2]

But the royal policy in regard to monopolies continued during the reigns of the sovereigns who succeeded Elizabeth, who died in 1603. This practice led Parliament to enact the Statute of Monopolies in 1624 which provided:

> "That all monopolies, and all commissions, grants, licenses, charters, letters patent, heretofore made or granted or benefits to be made or granted to any person or persons, bodies politic or corporate whatsoever, of or for the sole buying, selling, making or using of anything within this realm, or the dominion of Wales, or of any other monopolies . . . are altogether contrary to the laws of this realm, and so are and shall be utterly void and of none effect and in no wise to be put in use or execution."[3]

Certain exceptions were made in this act including the granting of patents for new inventions and new processes for a limited time, and the monopolies of foreign trade.

These monopolies which were so vigorously opposed by Englishmen in the early seventeenth century were markedly different from the industrial monopolies which give us concern to-day. These early monopolies were created by letters patent by the Crown. They were similar to the patent right of an inventor and to a franchise giving to one company the sole right to operate street cars, or sell gas, or supply telephone service to the residents of a certain community. They were not, as are

[1] H. R. Seager, *Principles of Economics*, 1923, p. 11.
[2] Seager, *ibid.*, p. 424. [3] Seager, *ibid.*, p. 424.

the modern industrial monopolies, created outside the law by the individuals who were to profit by them.

The granting of these early monopolies was an exercise of political control by the sovereign to the end that monopolies might prevail. The court decisions and the Statute of Monopolies represent political control, by other branches of the government, to the end that such monopolies might be prohibited.

The cause for this opposition is evident. Men of independent spirit desire an open field for talent, as is stated in the court decision of 1602 quoted above. Further, it is intolerable to vigorous men that they should be imposed upon by having to pay exorbitant prices, and that a few should grow rich at the expense of the well-being of the many.

Patents for New Inventions. — The opposition to monopolies to which reference has been made was tempered, as noted in the reference to the statute of 1624, by permitting the grant of a monopoly to a person who perfected a new invention or a new process. This principle was also recognized by the framers of our National Constitution, and Congress was given power to grant exclusive rights to authors and inventors.

The national law in regard to patents for new inventions provides that a patent shall give to the inventor the sole right to manufacture and sell his invention for a period of seventeen years. Congress alone has power to extend the life of a patent.

The American patent law leads to results that are both good and bad. Invention is encouraged, and it is to this end that the law is primarily designed. Further, without the protection of a patent, manufacturers in certain cases, at least, would not believe themselves justified in expending the money necessary to develop a new process. For if the success of the invention were not assured, the money invested might be lost, while if it did prove to be successful, competition would perhaps make it impossible to-realize large profits.

On the other hand, the patent law operates to some degree to permit the true end of the law from being realized. Its aim is to encourage inventions with a view to serving the public good by providing new forms of economic equipment or processes. But

patents may be taken out and not used. Thus large corporations often secure or purchase patents in order to escape the competition of the new device, and then leave the process unused. In such cases they obviously believe it more profitable to continue to manufacture their old product rather than to take up the new. In some instances a patent might be purchased even though the new product was deemed to be inferior to the old one, as even the competition of an inferior product is not to be desired; but it seems reasonable to believe that such purchase of a patent with the intention of not using it would usually take place only when the new invention was deemed to effect an improvement in the article being sold. It is the competition of such an article that is feared most heartily. But it is, of course, detrimental to social welfare to have such new devices suppressed.

It has been proposed in regard to this feature of our law that provision be made for the revocation of a patent if use is not made of it within three or four years of its issuance. This plan is followed in certain foreign countries, and is apparently a simple remedy for an admitted evil.

The patent law also leads to unfortunate results in some cases, because many persons may have worked upon the project but the patent may be secured by the one who did only the work necessary to carry to completion the work of the others. It is also contended by some that inventive genius does not need the stimulus of a patent reward. Perhaps the research departments of the large industrial concerns, out of which a large portion of our new inventions come, would not be discontinued if the patent system were abolished. The competition of rivals, and the zest for new accomplishment might be sufficient to lead to the continuance of research in such establishments. But even if the hope of a patent monopoly is not necessary in many cases, the provision does seem to be on the whole advisable. The desire for riches is a strong spur to activity, and if monopoly patents were not issued it is reasonable to believe that much less activity would be devoted to research upon new projects than is now the case.

Inventions have, obviously, been of great significance in our economic life, and especially so, during the past seventy years. Indeed, all of the modern methods of production that make it possible to fittingly characterize this as the age of science, or the age of machinery, are the fruits of invention. Many of the inventions of the past fifty years have yielded large fortunes to the inventors. Among these may be mentioned the Bell telephone, the Bessemer process of steel manufacture, the McKay sewing machine for the manufacture of shoes, the Mergenthaler linotype, and the Edison electric lamp. Also, of course, these inventions have contributed largely to the common economic life.

Some of the patents gave the patentees an opportunity by means of "tying" contracts to force the purchasers of the patented article to buy accessories from the patentees, and hence augment their monopoly profits. Thus the Shoe Machinery Trust controlled the patents on shoemaking machinery and refused to lease its machines (it never sold them) unless the manufacturer would purchase from it the accessories which it produced. This method was also followed by the A. B. Dick Company which sold its mimeographing machine with the license restriction that it might be used only with the stencil paper, ink, and other supplies made by the A. B. Dick Company. The United States Supreme Court, in 1912, upheld this practice as not being contrary to the patent laws.[1] Shortly following this decision, Congress inserted a provision in the Clayton Act of 1914 prohibiting the use of patents to secure "tying contracts."

The effect of patents in regard to monopoly profits is well put by Professor Seager in the following statement:

"Important as patents undoubtedly are as sources of monopoly income, it would be easy to exaggerate the extent to which they lead to the suppression of competition. A large number of them are for the protection of rival processes and serve to stimulate rather than to diminish competition among those employing the different methods. Only when a patented process is distinctly superior to all other known

[1] Dick *v.* Henry 224 U. S. 1 (1912).

processes for effecting the same result does it give rise to an exclusive monopoly, and even such monopoly is subject, of course, to the limitations which have already been discussed."[1]

The limitations to which Seager refers are the limitations on monopoly price such as were noted in Chapter XXIII above.

The copyright law is similar to the patent law. It provides for the granting of "the exclusive right to multiply for sale, copies of works of literature or art." The right runs first for twenty-eight years with the privilege of renewal by the author or his direct heirs for an additional period of fourteen years.

The Post Office. — The business of carrying the mails is a monopoly of the National Government. It is hardly conceivable that any progressive people would leave this work to the conduct of private enterprise, certainly not to several competing companies. The convenience and importance of a single unified system make monopolization imperative. Further, the contribution to the general social welfare — the educational and political gain — which results from a cheap system of mail delivery makes it desirable that this work should not be conducted for profit. Indeed, the postal receipts in this country are often insufficient to pay the cost involved and the deficit must be made up from the National Treasury. The simplicity of the work involved makes this function one that can be efficiently performed by the political government, even if we assume, as is usually done, that a business that is highly technical in its operations can be better performed under private enterprise than by a government agency.

Municipal Monopolies. — Reference has been made in earlier chapters to the desirability of monopolization in the case of many economic services that are vital to the welfare of the inhabitants of a modern city. Neither water, gas, electricity, telephone service, nor street railway transportation can well be furnished by competing companies. It is almost imperative that each be furnished by a monopoly. Indeed, if an attempt is made to foster competition, as during the early history of street railways, consolidation of the competing companies is almost

[1] Seager, *ibid.*, 429.

certain to take place. The one that gets an advantage over the other can drive it into bankruptcy through the operation of the principle of decreasing cost as the fixed plant is used more and more to capacity. If the larger street car company should carry passengers that formerly patronized the smaller one, this would involve but little extra cost to it, and hence a net gain, but this would be a very serious loss to the smaller company as its expenses would not decrease appreciably as it lost the traffic in question. Thus the larger company could afford to cut rates in order to get more business, and this would tend to ruin the other company. Hence, as such warfare gets under way, the smaller company must sell out to the larger company or, finally, lose out entirely.

Telephone service is, clearly, inherently monopolistic so far as efficient service to the people of a city is concerned. The needless duplication that would be involved in having rival water, gas, and electric companies, and the fact that the unit of most economical size for these services is not less than that needed to serve most cities, means that monopolization is far more economical than would be the providing of these services by competing companies. The desirable limitation upon the use of the streets also makes monopoly desirable in these cases.

The fact of monopolization, as was stated in the chapter on monopoly price, makes it imperative that the rates (the prices) for these services be determined by public authority. There is, in fact, only one alternative to regulation, if prices are to be reasonable, and that is government ownership and operation. This need for regulation has led to the use of the term *public utilities* to designate such companies, and, similarly, this need for regulation has led the courts to hold that such lines of business are "affected with a public interest." But, as was said in the chapter to which reference has just been made, the utilities furnished by such companies are no more vital to the public than are the utilities furnished by grocery stores or coal companies, neither are they any more "affected with a public interest" than is a milk distributing company. The simple fact is that since competition does not prevail, regulation is

necessary in order to assure good service at reasonable prices. It is out of this fact that they have come to be called public utilities; it is because of this that the courts hold that they are affected with a public interest and then gravely conclude that, hence, they are subject to regulation.

When regulation is decreed by the lawmaking body (national or state) and upheld by the courts, what had formerly been a private property right is thereby curtailed or abolished. In other words, property is confiscated. Property rights are perhaps more strongly protected against confiscation in the United States than in any other country.[1] This comes from the fact of our dual government and, as part of this, our written national Constitution and the system of judicial interpretation thereof. "No state," according to the fourteenth amendment to the national Constitution, "shall take life, liberty, or property without due process of law," nor, according to the fifth amendment, may Congress do this. Hence any law, state or national, that provides for regulation may be called in question as being in violation of the national Constitution. The final decision in such a matter rests with the United States Supreme Court.

But in England, for example, Parliament is supreme as a lawmaking body. Its laws may not be called in question by any court. But in this country, as indicated, the courts are supreme as they may declare legislative acts unconstitutional and therefore void. This fact gives property rights in this country a security against confiscation which they do not have elsewhere. Provision for the review of legislative acts by any group of men would give some protection against the legislature (or Congress), because of the normal differences of opinion among men. But a review by the courts gives an extra amount of protection since judges are normally very conservative.

A decision in our courts on a question of the regulation of private property under either of these two amendments to the national Constitution, turns on the point as to whether the

[1] Compare article by A. T. Hadley, "The Constitutional Position of Property in America," in *The Independent*, April 16, 1908, vol. 64, p. 834.

regulation was made by "due process of law." And this means whether the judges believe the regulation to be "reasonable." If they so believe, they hold that due process is not violated and thus the regulation will be allowed to stand. Hence, although our judges are the final arbiters in such matters, and although judges are usually conservative, it is possible to extend the regulatory power. In general, the social need is the final determinant of political laws. Changing aspects of life generate new attitudes and lead to the development of new institutional methods of control. In other words, institutions are adjusted so that they will serve new social needs. This is done slowly in this country, but it is done.

One of the outstanding legal cases involving this point is Munn v. Illinois, which was decided in 1876.[1] The Illinois legislature had passed a law regulating the rates and practices of grain elevator companies. The companies whose practices — whose property rights — were thereby curtailed contended that the legislature had taken their property without due process of law. The Supreme Court of the United States held, however, that the regulations in question were reasonable and hence that the due process clause of the national Constitution had not been violated. Thus judicial sanction was given to the principle of regulation. But even if this and other cases had been decided otherwise, it is practically inconceivable that such an attitude of the courts could have long been maintained. The regulation of rates in such cases was becoming so vital to social welfare during the late seventies and the eighties as a result of the growing dependence on certain monopolies, that no provision of the Constitution, and no group of judges could have long prevented it.

The importance of the problem of regulating these public utilities is further attested to by the tremendous figures at which their economic value is reckoned. In 1919 the total capitalization of the electric railway, light, and power systems, gas companies and wire communications (telephone and telegraph) stood at 17 billion dollars. Railroads, another public utility, were valued at 20 billion dollars.[2] In contrast with these, the

[1] 94 U. S. 113. [2] For more recent data see Chapter LVI.

foundry and rolling mills of the country were valued at $3\frac{1}{2}$ billion dollars and textile mills at 3 billion.

The Basis of Rate Regulation. — The basis of regulation is often said to be "a fair return on a fair valuation." This is axiomatic. No one could, or would, object to it. But so soon as one attempts to define what is meant by a "fair" or a "reasonable" rate, or a "fair" or a "reasonable" valuation on the property concerned, differences of opinion are likely to arise.

Perhaps the best general working principle in this connection is that these companies must be permitted to earn at least a sufficient sum, or rate, so as to insure efficient service for the immediate present and future. This is the minimum below which rates should not be allowed to fall. But just how high rates need to be placed in order to secure this end is a difficult question. Another phrasing of this problem is: at what rate of return and under what conditions will an adequate amount of capital and an adequate supply of efficient management and labor be forthcoming for the utility in question?

Not only should such a rate be the minimum, it should also be the maximum. The people should not have to pay more than is necessary in order to secure the service in question. The receipt of cost plus a reasonable profit is normally sufficient to encourage production in any line of endeavor and thus may be considered sufficient in this field. Or in other words, if a reasonable rate of return is earned on the investment — on the cost — this is normally sufficient to secure goods and services in any line of endeavor, and hence is adequate in the field of public utilities.

This idea of investment needs to be limited. It is not necessary that reasonable returns be permitted on the actual investment, but rather that reasonable returns should be permitted on what the investment would have been if it had been made prudently. Such returns will assure an ample flow of money funds into the public utility field. In contrast with this it may be argued that the cost of production, even if it were not made prudently, should be used as a base upon which to compute reasonable returns; or that the cost of reproducing — of purchasing to-day — the equipment and land that are involved

should be the base; or that the cost of reproduction less depreciation charges should be used. The last named of these bases is generally considered to be tantamount to present value. The difference between this and prudent investment may be very marked.

Consider in this connection the questions that arise when there is a marked change in the price level. If an investment is made, prudently, and if subsequent to this the price level rises, should the rates be limited so as to permit only a reasonable return on the investment? Or if the price level should fall subsequently to the investment, what base should be used? What of the interests of present security holders who have purchased at high prices? Again, if a public utility is not being managed efficiently should this be taken into consideration in determining a fair rate? And what of an appreciation in the value of land owned by the public utility? Should it be allowed to earn at a higher rate on its original investment merely because its land has appreciated in value? Or, on the other hand, should an appreciation in land value be considered as earnings and thus be used to justify a reduction in the rates charged by a public utility?

All of these questions can be answered by holding to the base of prudent investment. That is, the fact of changing price levels need not alter the base. In either case, investors may be allowed returns upon their investment, if it was made prudently, regardless of later changes in the level of prices. This would seem to be fair. Further, it seems proper to proceed on the assumption that a public utility must be managed efficiently, and that rates may be set only high enough to yield reasonable returns under good management. Then, too, in regard to the appreciation of land value, much can be said for holding to the base of original prudent investment. It may be argued that the usual owner of land profits from an increase in its value, and that not to permit a public utility to do so — not to permit it to raise the base on which reasonable return is to be computed — amounts to an unfair discrimination against it. But a public utility is in a class apart from other owners. If its land falls in value, it would desire to continue to use the original purchase

price as the base — and the principle of prudent investment would call for such a procedure, if the purchase had been made prudently. But an ordinary owner could not do this. A fall in the value of land would mean to the usual owner a loss in income. Furthermore, the land purchased by a public utility and used by it is, in most cases, permanently dedicated to such use. What may be the course of the prices of adjacent land or of that land, may properly be held to be of no concern to the public utility. Since its land is not for sale, its price — other than the original prudent investment — may be left out of consideration.

Actual cost of production, if made prudently, rather than the cost of reproduction, appears to afford the proper base for rate making. Reasonable earnings on such a base would seem to be sufficient to attract the necessary capital. Certainly, investors are concerned with returns on the amount that they invest, and not with returns on the later value — the reproduction cost — of the equipment that will be purchased with the money that they furnish. In short, returns on the cost of reproduction, rather than on the actual cost of production, in the very nature of the case cannot affect the supply of forthcoming funds. Further, if a plant is built at government expense, the amount actually expended is the significant item in later computing the cost of the property and not the then cost of producing (reproducing) it. Reproduction cost does not then appear to be acceptable as a base for rate making. In addition, it is an extremely difficult and expensive task to ascertain reproduction cost. But the records of the companies, if they have been kept, should reveal their actual costs, and can be checked for cases of imprudent expenditure.

The above analysis runs in terms of the minimum charge that will secure good service in the public utility field. The analysis that is usually followed by the United States Supreme Court is altogether different from this. It runs in terms of property rights. Reasonable rates must be permitted on present — "spot" — value, according to the court, in order that there may be no taking of property without due process of law. If the

price level has doubled since the land and equipment were purchased, the present prices must be accepted for rate making. The conclusion of the court in the Indianapolis Water Company case, decided in 1926, was unequivocal on this point. It said, "By far the greater part of the company's land and plant was acquired and constructed long before the war. The present value of the land is much greater than its cost; and the present cost of construction of those parts of the plant is much more than their reasonable original cost. In fact, prices and values have so changed that the amount paid for the land in the earlier years of the enterprise and the cost of the plant elements constructed prior to the great rise in prices due to the war does not constitute any real indication of their value at the present time."[1]

The court, however, was not unanimous in this decision. Justice Brandeis dissented. Similarly in the Southwestern Telephone Company case,[2] decided in 1923, the majority of the court held that the then value of the property must be used as a base in setting rates, despite the fact that the value of the property greatly exceeded the cost that was incurred in making it available for the use of the public. Justice Brandeis dissented and cogently argued in favor of the use of prudent investment. He says, "The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise." It is thus the money investment, according to Brandeis, that the Constitution protects, and not specific items of property that may have risen greatly in value since they were purchased. "So long as the specific items of property are employed by the utility, their exchange value is not of legal significance."

This analysis by Brandeis is sharply different from that of the majority of the Court. His argument proceeds from the idea of function, while that of the majority does not. The

[1] John W. McCardle et al v. Indianapolis Water Co., 47 Sup. Ct. Rep. 144 (1926).

[2] State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Missouri et al., 43 Sup. Ct. Rep. 544 (1923).

majority in the cases cited, are not concerned with the question as to the method of valuation that will secure public utility service at the least cost to the public. Their point of view is that of the conservation of the property rights of private owners. But this point of view does not necessarily lead to the conclusion that "spot" value rather than "prudent investment" shall be used as a basis for rate making. If the rule of prudent investment were adopted and followed consistently, the property rights of the owners would remain at this figure, and later courts in protecting the property rights of owners of public utilities would need to protect only such sums.

The Supreme Court, however, does not always follow the rule of "spot" value — reproduction cost less depreciation. It attempts to determine the value in any one case according to the "relevant items" in that particular case. Further, the personnel of the Court changes from time to time. This makes it still more difficult to predict the outcome in any case. Hence, a public utility commission in reaching decisions as to rates cannot be concerned merely with the question of the maximum rate necessary to attract capital, but it must try to fix a rate that according to the guess of the commissioners will be approved by five of the nine judges of the Supreme Court.

Careful students of this question have suggested that the states should enact legislation providing that the public utility commission should place a more or less arbitrary valuation on the present property and then carefully record all additional investments, such totals from time to time to be the basis for rate making.[1] But, of course, the courts might declare such laws unconstitutional, although they would perhaps not object to a provision that all new investments should permanently be reckoned at the prudent cost at the time that they were made.

It has also been suggested that the position might be taken by the commissions that, unless the companies would agree by contract to the actual cost basis, both for investments already made and to be made, they be refused all privileges, such as

[1] J. Bauer, *Effective Regulation of Public Utilities*, 1925, p. 55.

permission to new companies to enter the public utility field and permission to all companies to amend their charters or extend the scope of their operations.[1] There would seem to be no basis on which the courts could declare such contracts void.

The Capitalization of Income. — It is sometimes suggested that the property value of a public utility for rate making purposes should be determined by capitalizing its income. The method of capitalizing income, it will be recalled, is used to find the value of land and of bonds, for example. The method is, further, of universal applicability if future income is known or if it may be assumed to be a certain amount. But, clearly, if we are attempting to ascertain if public utility rates are equitable by determining the value of the property used, we become involved in a vicious circle if we assume these rates to be just and use the income that flows from them to find the value of the property on which rates should be based. If the rates are in question the income that they yield must be left out of the computation.

A variant of the proposal to determine value by capitalizing income, is that the market value of the outstanding securities of the public utility corporation should be accepted as the value of the property for rate making purpose. This is fundamentally the same as the capitalization of income, because the value of the securities is determined by the income. Thus for the reasons already noted, this method is indefensible.

The Rate Structure. — If the principle of cost is accepted as the proper base for the determination of rates, interesting questions then arise in the case of certain utilities as to the adjustment of rates to the various users so that they will all pay their proper share of the cost. One method of rate making is to charge all users the same amount regardless of the quantity used. This is called a *flat rate.* This is probably the oldest method. But, obviously, such a plan does not differentiate among users. It results in a division of costs equally among all. A refinement over this method is the *straight line meter rate.*

[1] P. P. Wells, in the *National Municipal Review,* Oct., 1926, cited in the *New Republic,* Jan. 5, 1927, p. 182.

This involves the use of a meter as in the case of water, gas, and electricity, and the charge of a flat rate per unit used. This leads to a more equitable division of cost among the consumers than does the non-meter plan, but it is still a rather crude method. Suppose that one customer uses a very small amount of electricity per month, and another ten times that much. Since the cost of supplying and installing the wires and the meter is the same in the two cases the cost to the company will not be ten times as great in the second case as in the first one. Merely getting ready to serve a customer involves a cost which may not be paid for under a straight line meter rate. To remedy this situation, what is called a service charge is sometimes provided. This is at times designated as rental charged for the use of a meter, or in the case of telephones, a charge for installation, and perhaps, also, rental for the instrument.[1]

Another scheme in relation to this feature is to vary the rate with the amount used. Thus a high rate may be charged for a small number of units per month, and a lesser rate for successive quantities. Another illustration of this problem is found in the demand of a large office building for a large amount of electric current for its elevators during certain periods of the day. To be able to care for this peak load, the electric company must install special equipment, and further the heavy installation required means that the loss of energy is greater than it would otherwise be during the remainder of the day. Hence, if the company can charge only the usual meter rates for the extra peak load current, the customer will not be paying the cost involved in furnishing this service.[2]

A further refinement in the apportionment of cost among different customers is made by varying the rate according to whether the demand is made at the peak load period per day or at some other time. Electric power companies, for example, until very recently have been drawn upon most heavily for

[1] Compare article by C. O. Ruggles, "The Significance of Minimum and Service Charges in Rate-making for Public Utilities," *Journal of Political Economy*, Vol. XXXII, Feb., 1924, pp. 56–67.

[2] Ruggles, *ibid.*

power during the early evening. Thus their facilities had to be adequate for this period. Hence the cost to them of furnishing current during the day was considered to be less than during the night, since it was then that the major demand came. Accordingly, rates for day use tended to be less than those for night use. Or, more practically, lower rates were given to manufacturers whose principal demand came during the day, than were given to householders whose demand was principally at night. Further, such a differentiation in rate was to the advantage of the householder, because it encouraged the daytime use of electricity, and by leading to a fuller utilization of the power plant reduced the cost — and thus the rates — for the night service.

This distribution of load between day and night and the difference in rates still prevails in many places. But the increased use of electricity for power as contrasted with light is rapidly altering the situation. Power is coming to be the major source of the demand for electricity. The higher rates to householders may be continued, but if so this will be based on the principle of what the traffic will bear. Many observers insist that lower rates to householders would greatly increase their use of electricity and thus prove to be profitable to the power companies. The practice in some places is to provide two installations for houses and charge a lower rate for power than is charged for light.

Public Utility Accounts. — Many questions pertaining to the cost of furnishing service to a public utility are omitted from the above discussion because of the limitation on the size of this book. These include questions of depreciation of equipment, the building of new equipment beyond present needs, losses during bad years, abnormal profits during good years, risks of loss, as in the natural gas business, and the effect of fluctuations in the rate of interest. But the analysis given and the citation of these topics are sufficient to merit the conclusion that public utilities should keep their accounts according to specifications by government authorities. Such industries cannot be considered private and secret. Their books must not only be open for inspection,

but should be kept so as to reveal the data that are pertinent to the problem of rate regulation.

Types of Regulation. — The first attempts at regulation were made directly by state legislatures through the specification of rates. This was soon found to be a very inefficient method, and administrative commissions were provided to perform the work of regulation. In many states this takes the form of a public utilities commission which has very extensive power in this particular over the various public utilities.

Obviously, regulation by a commission is far better than regulation by a legislature. The commission becomes a permanent or a somewhat permanent body of men devoting themselves to this particular task. Not only does such a body tend to become expert at such work, as compared with a legislature, but there is, furthermore, a degree of flexibility in control — a power to adjust methods to needs — that could not prevail if the details of regulation were definitely prescribed by statute.

But whether the legislature attempts to do this work directly or provides that it be done by a commission, the courts have final power in any case that is contested. Thus if a public utility feels that a rate established by the government agency is unreasonably low, it may appeal to the courts on the ground that the rate is so low that its property is confiscated. The decision of the Supreme Court is binding.

Franchises. — The various public utility companies operate under franchises that are granted usually by the municipalities concerned. Some of the early franchises granted in this country were without time limit or for ninety-nine years or more. The indefensibility of this practice was soon apparent and a limit of twenty-five or some other period of years was specified. It is advisable that the franchise period be long enough to warrant the company in providing equipment that will give efficient service, or what amounts to the same thing, a sufficient period to permit the company to borrow at reasonable rates of interest the money that it requires for efficient service. But the franchise period should not be so long that a marked change in conditions might bind the municipality for a long period to terms that were

less advantageous than could later be made. Further, franchises should be drawn in general rather than in detailed terms. That is, instead of attempting to settle details as to rates and service this should be left to the determination of the public utilities commission from time to time.

The question as to the desirability of government ownership of public utilities will be discussed in a later chapter. The present discussion has been entirely in terms of private ownership. But, clearly, private ownership with strict government regulation, such as prevails to-day, is far from private ownership as we find it in most lines of enterprise. Regulation cuts into the "privateness" of private property. It is a step in the direction of government ownership, even if that stage should never be reached.

PROBLEMS AND EXERCISES

49. Sketch the principal outlines of a society in which there would be no need for social control.

50. Illustrate the two forms of social control by reference to a college or university.

51. Should the following be furnished to the residents of a city by a company having a monopoly, or by competing companies: water, ice, gas, electricity, milk, bread, telephone service, street railway transportation, taxicab service? Give reasons for conclusion in each case.

52. "If a patentee does not make use of his patent it should be revoked." Do you agree? Discuss fully.

53. Explain the meaning of the term *public utility*.

54. The cost of the J. K. Street Car system to date has been $1,800,000. It is claimed on good authority that the total outlay need not have been more than $1,500,000. It would cost $3,000,000 to replace it with new equipment, and $2,000,000 with equipment of the state of depreciation as at present. What would you suggest as a reasonable amount for this company to be allowed to earn each year? Why?

55. Assume that an electric power plant is constructed and that no repairs will need be made for ten years, but that between the tenth and the twentieth years the plant will need to be practically rebuilt. Should the rates for the first five years be enough to permit something to be saved for replacement of plant later? Discuss.

56. The XY company uses electric power from 1 : 00 A.M. to 6 : 00 A.M. Its rate is much less than the rate paid by housewife Jones

or by the Anderson office building. Can this difference be justified? Explain.

57. "The franchises granted by these cities are the best possible for the gas companies." — A dealer in gas company bonds.

(*a*) Name some of the probable stipulations in these franchises. Suggest some probable omissions.

(*b*) How should you wish the franchises changed if you were a citizen of one of these cities? If you were a citizen, but at the same time a subscriber to the stock of the gas corporation?

58. Consult a copy of the United States Constitution and get the exact wording of the fifth and the fourteenth amendments.

REFERENCES

M. G. Glaeser's *Outlines of Public Utility Economics*, 1927, gives a good comprehensive account of the problem of public utilities. The book by Bauer referred to in a footnote above is an excellent analysis of rate regulation.

C. O. Ruggles, in the *Journal of Political Economy*, February, April, and October, 1924, Vol. XXXII, Nos. 1, 2, and 5, discusses several interesting problems pertaining to public utilities. The article by President Hadley referred to in a footnote above is well worth reading.

The student should read at least a few of the court decisions designated in the footnotes to this chapter.

CHAPTER XXXVII

CONTROL OVER RAILWAYS

The railroad is so important in the economic life of the nation that it will be treated in a chapter apart from the other public utilities. The significance of the cheap and efficient transportation of the railroads in our common economic life has been referred to in many places in the preceding pages. Especial emphasis was given to this point in the discussion of specialization and trade. In that place a quotation was given from Adam Smith that contrasted for his time the marked cheapness of water transportation with that by land. But about fifty years after the publication of Smith's book, the steam railway came into being. The first steam railroad in the United States was the Baltimore and Ohio, the first rail of which was laid in 1828. The date 1830 marks the beginning of the first successful steam railroad in England, but there were *railroads* there in the seventeenth century. By the middle of the eighteenth century the railroad with steam as power, of course, was a very important factor in our national life, and it has continued to increase in importance up to the present time.

Not only has the railroad been of great significance in our economic life in making possible the extensive specialization that prevails throughout the nation, but it has also been of tremendous significance in the social and political aspects of our life. To the railroad more than to any other one agency is due the fact that we are one political nation in an area of 3,000,000 square miles and one cultural unit of more than 118,000,000 people. Without the railroad, the commerce and the communication necessary to make the inhabitants of this region one people would have been lacking. The divergent rather than the common interests of the different regions and the different groups

would have gained the ascendancy, if the railway had not been developed.

This is to say that if the railway development had come a century or two later, or if the settlement of this continent by the English and Europeans had taken place a century or two earlier, what is now the United States would undoubtedly be broken up into a number of separate and independent nations of divergent languages, as is true of the continent of Europe, and, incidentally, as in Europe, each of these nations would be trying through protective tariff duties to restrict the commerce of the others, and would be succeeding not only in doing this but in restricting its own commerce as well. Indeed, the extension of railway service over the Rocky Mountains to the Western coast in the seventies (the first transcontinental line was completed in 1869) appears to have been in the nick of time to prevent the Pacific Coast region from becoming politically independent of the remainder of the country.

The automobile has become an important means of transportation during the past decade, and service by aeroplane is being developed rapidly. Each of these lines of development throws into relief the general problem of the relation of transportation to the common economic life of the people of the nation. But despite the growing importance of these means of transportation and the continued importance of inland waterways, including the Great Lakes, the railway is still of outstanding importance in our system of transportation.

The Railway Industry To-day. — In 1920 the railroads of the United States comprised a system of over 250,000 miles of road, much of which is double track. This is equal in extent to ten roads around the world, and to seventy-eight between New York and San Francisco. The railways employ about 2,000,000 persons, which is about 5 per cent of the total number of persons that are gainfully employed. Further, the equipment used in the railway industry is so extensive as compared with most other lines of industry that the relative importance of the industry is greater than is indicated by the portion of workers that are engaged therein. The capitalization of the railroads in 1920 was

$20,098,000,000, of which amount $11,255,000,000 was funded debt and $8,843,000,000 was capital stock. This is approximately ten times the capital stock and surplus of all of our national banks, and only slightly less than the value of all of the manufacturing plants in the nation.[1]

In 1923, the railroads carried 456,237,000,000 net ton-miles of freight, which was equivalent to the movement of 4,545 pounds of goods 5 miles every day in the year for every man, woman, and child in the country. Also, during that year, the railroads furnished 37,957,000,000 miles of passenger transportation, or the equivalent of a trip of 345 miles for every one of the 110,000,000 persons comprising the population of the country.

The Railway Problem. — The railway problem may be divided into two parts. First, there is the problem of the technical improvement and technical efficiency of the industry. Considerations relative to engines, cars, roadbed, tracks, safety devices, and general operation come within this group of problems. Second, there is the problem of the proper adjustment of railway operation to the general economic life of the nation. The first of these series of problems is primarily within the field of engineering. With it the economist has but little concern, except that he is interested in having such arrangements made that technical efficiency will be encouraged and developed. It is the second division that the economist is especially interested in. This division includes such problems as the rates to be charged and the treatment that is to be accorded the different shippers.

Social Control. — The consideration of the railway industry raises again the question of social control. Government regulation of the railroads has been proved to be as imperative as the regulation of the municipal monopolies discussed in the preceding chapter. The history of railways in the United States shows a continuous development in the direction of closer and closer supervision by government authorities over the business of the railroads. In the beginning, as was most natural, reliance was placed upon the forces of competition to secure to the public

[1] Eliot Jones, *Principles of Railway Transportation*, 1924, p. 4.

transportation service on fair and equitable terms, just as this force was, and is, relied upon to secure to the public food and clothing of proper quality and price. But it was soon apparent that the general interest was not being well served by this method. Accordingly, the various states began to regulate the railroads within their borders. This movement began about 1870. Finally in 1887, the National Congress enacted a law which prescribed several detailed rules that were to be obeyed by the railroads and established the Interstate Commerce Commission, which was to look to the enforcement of these rules. The rules then provided have from time to time been found to be inadequate, and have been extended. The latest law — the Esch-Cummins Act, or the Transportation Act of 1920 — made very significant additions to the regulatory laws already enacted. These additions will be noted later.

Why Has Regulation Been Desirable? — To ask the question: why has it been desirable that special regulations governing the railroads should be provided by the state and national governments? is to ask why competition did not, or could not, secure as satisfactory results in this field of economic endeavor as in most fields of business enterprise. The answer is found very largely in the word *discrimination*. That is, the nature of the railway industry is such that it is practically inevitable that the different roads, if left to themselves under private management, will discriminate among the various persons who wish to purchase transportation services. Further, transportation by rail is so significant in the present day economic life that discrimination has very important and unfortunate effects on the general social welfare. In addition to the feature of discrimination, there is also the aspect which makes the regulation of municipal monopolies necessary, namely, in order that the private owners will not profit unduly at the expense of the public. That is, regulation is called for in order to prevent rates from being unreasonably high. But, to repeat, in the case of the railways, the discrimination among shippers, which almost inevitably arises if roads are owned privately, is the principal reason for regulation.

The Effect of Railway Discrimination. — In most lines of economic endeavor, the effect of discriminating in favor of certain persons and thus against other persons is of but little, if any, social consequence. If a merchant should sell goods to some of his customers at a very low price, or should give them goods without charge, this need not concern the other customers. Such discrimination by wholesale dealers or by firms that sell rare materials might be undesirable socially as it would tend toward monopoly by giving a few of the purchasing firms an advantage over the others. But it is not at all probable that such sales would have such serious results as flow from railway discrimination, and further, such discrimination in the sale of goods is not nearly so likely to take place as is discrimination by the railroads in the sale of their services.

Almost every line of enterprise is dependent on railway service. Without the outlet of markets in which to buy and sell, which the railroad affords, most enterprises would be not merely limited in their activity but unable to exist. If the owners of certain coal mines cannot get cars in which to ship their coal, they are effectively prevented from operating their mines, and other mine operators are able to reap profits that would otherwise be denied them. If certain manufacturers should be charged unduly low rates for transportation, this might make it possible for them to drive their competitors out of business and thus establish a monopoly.

One striking, but by no means exceptional, illustration of discrimination of this sort is found in the contract between the Standard Oil Company and the Cincinnati and Marietta Railroad. According to the terms of this agreement the railroad was to carry Standard Oil from Macksburg, Ohio, to Marietta, Ohio, for 10 cents per barrel and was to charge all other oil companies 35 cents per barrel. Furthermore, the railroad was to pay to the Standard Oil Company 25 cents out of the 35 cents collected from the independent companies for each barrel of oil that they shipped. Such a contract, and the Standard is reputed to have had many similar, though less favorable ones, so tipped the scales of competition against the independent oil

companies and in favor of the Standard that the success of the latter at the expense of the independent companies could not have been prevented. Such discriminatory practices were especially prevalent during the seventies, eighties and nineties. They were declared illegal by the law of 1887, but as late as 1898 the Interstate Commerce Commission said, "There is probably no one thing today which does so much to force out the small operator and to build up those monopolies against which law and public opinion alike beat in vain, as discrimination in railroad rates." [1]

Further, if one commodity is transported by the roads at a relatively high price and another at a low price, this may have serious consequences to some of the parties concerned. Thus the freight rate on flour was at one period so high relatively to the rate on wheat that millers in Minnesota were placed at a great disadvantage with the eastern millers in the eastern markets and abroad. It was charged that these rates were deliberately adjusted in this way in order to favor the flour manufacturers in the East. Whether or not this was true, there is clearly no escape from the conclusion that the rates were to the serious disadvantage of the western millers, and that, in general, the relative rates on raw material and finished goods may amount to a serious discrimination in favor of the producers in one section of the country.

Why Railroads Discriminate Among Shippers. — How can we account for the fact that railroads discriminate among shippers? Why shouldn't they treat all of their patrons the same? There are two answers to these questions. In the first place, a railroad involves a large fixed investment. The roadbed, track, switching yards, stations, repair shops, and rolling stock are so expensive that so long as they are not fully used, additional service may be furnished at but little additional cost. The principle involved is that which is applicable to any piece of industrial equipment, namely, so long as it is not used to capacity additional output can be procured at a decreasing cost per unit.

[1] Quoted in Patterson and Scholz, *Economic Problems of Modern Life*, 1927, p. 197.

But this is especially significant in the case of railroads. Their plants are unduly expensive, as was indicated by the reference above to the value of the roads, and almost from the beginning of our railway history, our roads have, until recently, been greatly overbuilt. During the five years from 1867 to 1873, 33,000 miles of roadway were constructed, and from 1880 to 1890, the total mileage of the country was almost doubled, increasing from 93,000 miles to 163,000 miles. The growth in population and business was not at all sufficient to warrant these great extensions. The country was "railroad mad." Huge fortunes were made in building roads and selling securities to the general public. This was an important incentive in the building of roads. The promoters expected to sell the roads and not the services from the roads. But at any rate, the roads were overbuilt during the three decades following 1870, and this meant that most of them could increase their profits (could reduce their losses) by secretly cutting rates to large shippers.

This goes back again to the fact that railways are very expensive and that, in most cases, they are not being used to capacity. It is estimated that, in the usual case, two-thirds of the expense of a railroad is constant regardless of the volume of traffic, and that, even of the operating expense alone, one-half is constant.[1] Under such a condition, to consider the estimate in regard to operating expenses, if the traffic increased by 10 per cent, the cost of operating the road would increase by only 50 per cent of 10 per cent, or 5 per cent, since 50 per cent of the operating expenses are not dependent on variations in the volume of traffic. Hence, the road could afford to carry 10 per cent more traffic for something above 5 per cent more in revenue. An addition of 7 per cent to revenues would thus reward such a road handsomely for carrying 10 per cent more freight. In other words, it could well afford to carry the additional 10 per cent of freight in question at but 70 per cent of the rates charged for the other freight, as such rates would increase revenues by 7 per cent if the traffic increased by 10 per cent.

The above analysis is often given as if it were universally

[1] Eliot Jones, *op. cit.*, p. 78.

characteristic of the railway industry. The railroad, we are told over and over again, is subject to decreasing cost. But it must be emphasized again, this is true only in so far as a road is not yet used to capacity. Such a condition may prevail generally as in our early period of railway construction, or in the case of most roads it may be found after any major increase in equipment. Thus if a road has grown to the capacity of one track and then builds another one it will normally be in a condition of decreasing cost for additional units of service. But before making this addition to its plant, it may have been in a condition in which additional freight could not have been carried profitably even at abnormally high rates. Thus the assumption of decreasing cost is not universally valid for railways, but it is sufficiently prevalent to warrant the statement that discrimination in the case of most railroads may usually be profitable, if this will secure an additional volume of traffic.

In addition to thus practicing discrimination in order to increase its operating revenue, a road may discriminate among shippers because those who control the interests and policy of the railroad may also have interests outside of the railroad business which they wish to serve by means of the road. Thus if railway officials own large blocks of land in a certain section, or near a certain city, they may grant especially low rates both for freight and passenger service to and from this place. Or, if railway officials own mines, or timber, or other raw materials, especially low rates may be made on shipments from the localities where their holdings are found.

Kinds of Discrimination. — The discrimination practiced by the railroads is commonly classified into three groups as follows: discrimination among persons, among commodities, and among localities. The illustrations given above represent each of these groups. This classification is significant, but it is slightly unfortunate in that it carries the suggestion that only one of these kinds of discrimination is among persons. Any discrimination to be significant must affect persons. "Discrimination among commodities" is really, of course, discrimination among persons on the basis of goods which they ship, and "dis-

crimination among places" is, similarly, discrimination among persons on the basis of the places from which goods are shipped.

Each of these three kinds of discrimination has unquestionably been practiced without any social justification for doing so. And together they have been largely responsible for the railway legislation which began in 1870 and has continued to the present day. But it must be noted that the question of discrimination among commodities is a very intricate one. Rates cannot be the same upon all goods. The charge per barrel or per ton cannot properly be the same for hay, wheat, steel, limestone, silk, and jewelry. When are the relative rates discriminatory, that is, unfair? Just what shall the relative rates be on the different articles transported? Some of the phases of this question will be noted presently. The point to be made here is that what may appear to be discrimination may be justifiable differences in rates for different commodities.

Similarly, rate differences among localities may be justifiable. Indeed, it may be to the advantage of the shippers at the places to and from which the high rates are charged. This question will be discussed later under the heading — "The Long and Short Haul Controversy."

The Level of Rates. — Not only does the matter of discrimination make it imperative that railway operation be regulated by law, but entirely apart from discrimination, the public interest may need protection against extortionate charges. This phase of the problem is exactly similar to the problem involved in the rates of municipal public utilities. Telephone companies, for example, are perhaps never guilty of discrimination, but they may easily demand more than a fair return for the service which they render. The need for the regulation of railroads on this score rests, obviously, on the fact that there may not be competitive control to prevent rates from being exorbitant.

Competition among roads, or between a road and a waterway, may act as an effective check on rates. But there are necessarily points on every road that do not have competitive transportation lines, and further, since competition, if it is effective, tends to breed discrimination, regulation would be necessary under

competitive conditions. Thus, whether there be monopoly or competition in the railway industry, regulation is necessary if the public welfare is to be promoted.

There is another important angle to this matter, as noted in the preceding chapter. That is, rates must be high enough to permit the road to give adequate service. Public regulation may easily be carried to the point that returns are not sufficient to encourage the railway development and improvement that is called for in the public interest.

Relative Rates. — As indicated above, the problem of relative rates is a difficult one. There are two basic principles in the determination of the rates to be charged for different goods. First, the transportation of different kinds of freight is subject to the principle of joint cost, and, second, as already noted, until the plant is fully utilized, the business is subject to decreasing cost per added service rendered. Both of these considerations take their significance from the fact of large fixed equipment in the railway industry.

It is this that makes the joint cost element important. For if the direct (special) expense for each shipment were relatively large, then the fixed expense, which is the large part of the joint expense for all of the services rendered, would be relatively small, and so of less account. And, to repeat, it is the large fixed expense which makes the cost per unit of service furnished decrease so markedly as the plant is more fully utilized.

The principle of charging the same rate per pound for all articles might be followed, with an additional charge for light bulky freight such as bird cages. This is the general rule in the case of transportation by pack mule or wagon, but the practice of the railways is to charge more for expensive articles than for cheap ones. The rate per pound is much higher for finished steel, for example, than for limestone.

This principle of rate making is thoroughly sound, not because it is intrinsically "just" that the persons who ship the more expensive goods should pay higher freight rates therefor, as is often said to be the case, but because this method of rate making leads to a more complete utilization of the road than

would the rate method followed by teamsters.[1] It is to the advantage of the general public that the expensive equipment of the road should be fully utilized. Further, it is to the advantage of all shippers that this be done in order that the road may pay expenses and continue to transport freight. Or, to alter the phrasing, it is to the advantage of any shipper that sufficiently low rates be charged for goods shipped by other persons so that they can afford to ship them, provided the rates be high enough to yield the road a net gain above the special expense that it would have to incur to ship the goods in question.

Suppose that a branch line road is principally engaged in shipping machinery from a manufacturing center, *X*, and charges $4 per hundredweight to carry it to *Y*. Suppose that it could transport cars of limestone from *X* to *Y* along with cars loaded with machinery, at an additional cost of $5 per car. If a cement plant at *Y* will purchase the limestone at $10 per car, and if the producer will deliver it to the cars at $3 per car, the road can then get this business if it will charge not more than $7 per car for transporting the stone. This will net the road $2 per car. This rate on limestone will, if a car carries 20 tons, be only $1.75 cents per hundred pounds, while the rate on machinery is $4 per hundred. But instead of the shippers of machinery objecting to this low rate on limestone, they can afford to encourage the railroad in this practice. For, the limestone business may develop to such proportions that the earnings of the road will be so augmented that it can earn reasonable returns by charging only $3.50 for transporting machinery to *Y*. Such a reduction we may assume would be ordered by the rate regulating body. Thus the specially low rate on limestone would be to the advantage of the shippers of machinery, and would contribute to the general social welfare.

This is the principle that has already been developed in earlier chapters. The more completely equipment can be utilized the lower will be the cost per unit of output. It is this that makes it justifiable to vary the freight rates on different articles

[1] Compare Taussig, *Principles of Economics*, 3rd ed., 1921, Vol. II, p. 398.

"according to what the traffic will bear," providing the rate on any one class of goods is more than sufficient to pay the special costs required to transport such goods, and providing the rates are not so high as to yield unreasonably high profits to the railroad. The proper principle for rate making is thus a combination of the two principles: (1) charge according to cost, and (2) charge what the traffic will bear. The charge for individual classes of goods should be according to what shippers will pay to transport them, but the total rates must not be so high as to yield undue profit to the railroad on the cost involved. Finally, the rates on any one shipment must at least slightly exceed the extra cost which it imposes on the railroad.

A Fair Return. — As has already been suggested both in this chapter and in the preceding one, rates must not only be fair to shippers, they must also be fair to investors. That is, rates must be high enough to permit the roads to earn sufficient income, if that is possible, to keep the roads in efficient repair and to attract to this field of investment additional money funds as they are needed. Such a level of rates is, clearly, to the long time interest of shippers. But, to repeat, rates should not be appreciably higher than this. The public should not be called upon to build up monopoly profits for the railroads.

There are three aspects to this question: First, what rate of return on the value of railroad property is fair? Second, how should the value of the property be ascertained? And, third, what group of rates will yield the "fair" return on the computed value?

In regard to the first of these, the Interstate Commerce Commission is at present proceeding on the theory that $5\frac{3}{4}$ per cent is a fair return. The second point is being answered at the present time by a physical valuation of the roads upon which the Interstate Commerce Commission has been working since 1913. It is generally assumed that the figures at which it arrives for the various roads, together with such actual additional investments as shall later be added, will be accepted as the base for rate making. The analysis involved here is the same as that developed in the discussion of a similar point in the preceding

chapter. In regard to the third point, it may not be possible for rates to be so adjusted that certain roads can earn a fair return. Further, rates in any case tend to be somewhat experimental when they are first set. They may either encourage or discourage the movement of goods. Hence, frequent revisions may be necessary.

The Long and Short Haul. — The determination of rates for long and short hauls has been the subject of much controversy. In 1886 a rate of $3.25 per bale of cotton was charged for shipment from Winona, Mississippi, to New Orleans, a distance of 275 miles, whereas the rate from Memphis to New Orleans, a distance of 450 miles, was only $1. In 1900, the rate on sugar from San Francisco to Denver was 75 cents per hundred pounds, but to Omaha, hundreds of miles further east, it was only 50 cents. In 1905, the rate on window-shade cloth from New York to San Francisco was $1 per hundred pounds, while from New York to Salt Lake City it was $2.30.[1]

The reason for such local discrimination is found, of course, in the nature of the railway industry, when the plant is not being fully utilized. To secure freight for shipment at competitive points, any one railroad can afford to reduce its rates to a figure that is only slightly above the extra cost involved in carrying the shipment. If such freight could not be secured otherwise, the low rate may be to the advantage of shippers at non-competitive points who have to pay higher rates, since otherwise a larger portion of fixed expenses of the road would fall on such shippers. But these considerations do not remove the fact that the shippers at non-competitive points are thereby placed at a disadvantage with the other shippers who receive low rates. Clearly, if the competition is merely between two railroads, it would appear to be socially desirable to prevent their competing for freight at rates below those charged at non-competitive points. And if the competition is between a road and a waterway, it would appear to be desirable to control the water rates so as to prevent the competition that may be disastrous to shippers at non-competitive points.

[1] Jones, *op. cit.*, p. 106.

In 1887, Congress made it illegal for a road to charge more for a short haul than for a long haul, under substantially similar circumstances and conditions, when the one was included in the other, but the Interstate Commerce Commission was given authority to make exceptions to this rule. This has been, and is still, done when a railroad has to meet water competition, because the Interstate Commerce Commission has no authority over water transportation. But this relief from "the long and short haul clause" is not given because of the existence of railway competition.

Pools and Rate Agreements. — The competitive pressure upon our overbuilt railways in the early period was so destructive of income as a result of rate cuttings, that the roads sought to eliminate it. One device was a pooling agreement. The roads entering into such an agreement promised to pool their receipts and then divide them without regard to the amount of freight handled. But as this was in violation of the competitive ideal for the railroads which was then highly cherished by the American public, this practice was prohibited under the law of 1887.

The roads then attempted to accomplish the same end by working agreements as to rates to be charged. That is, groups of roads agreed as to the rates that they would charge. Another similar attempt was made under the guise of traffic associations. It appears now that this was clearly in the social interest, but, this too was in conflict with the principle of competition which we were still trying to apply to the railway industry. Hence, such agreements were declared illegal as in violation of the Sherman Anti-Trust Law of 1890. It is interesting to observe that the formation of pools and the making of rate agreements were attempts at social control over the economic conduct of individuals by voluntary, autonomous, action on the part of these individuals. Railway managers were attempting mutually to control each other. But although we have finally given up the idea that rate competition among the roads is desirable, we have sought to eliminate it and control the rates by government authority rather than trusting the railroads to do this.

The History of Railway Regulation. — In its early stages railway regulation came solely from the various states. It arose largely from the failure of railway officials properly to serve the interests of the country, although this was augmented by the period of business depression that followed the panic of 1873. The complaints against the roads took two forms: one, that the charges of the roads were extortionate, and the other that they discriminated among shippers. The ensuing legislation is usually known as the Granger legislation, because the National Grange, a farmers' organization in the north-central section, was the prime factor in the movement.

The lead in the enactment of effective legislation was taken by the state of Illinois. The law passed in 1869 was ineffective, but in 1871 a series of important laws were enacted. These established maximum rates for passengers, forbade extortionate and discriminatory freight rates, and established a railroad and warehouse commission. These laws were declared unconstitutional by the Supreme Court of Illinois in 1873, but shortly thereafter (in 1873) a new law was passed that was eventually sustained in the courts.

In the words of a leading authority:

> "The Illinois legislation is important, as it constituted the basis for subsequent railway legislation, not only in Illinois, but in numerous other states that were influenced from time to time by the example of Illinois. The guiding principle of the legislation was the establishment of a mandatory commission, that is, a commission with power to regulate rather than merely to supervise and advise; and it became clear as the result of the experience of the next half century that the creation of these commissions represented one of the most constructive contributions that has yet been made to the solution of the railway problem."[1]

Other states followed the lead of Illinois. These included Minnesota, Iowa, and Wisconsin. And in all of them fierce legal battles ensued as to the constitutionality of the laws.

The position taken by the roads was that their industry could not be regulated — that the business was private — that private property rights might not be abridged — and that to interfere

[1] Jones, *op. cit.*, p. 190.

with the conduct of the roads was to take property without due process of law, in violation of the Fourteenth Amendment to the federal Constitution.

The question was finally settled by the decision of the United States Supreme Court in the so-called Granger cases in 1876. The leading case in this group is Munn v. Illinois.[1] This case, as noted in the preceding chapter, involved the right of the state of Illinois to pass a law establishing maximum rates for the storage of grain in elevators. The Court held that grain elevators were "affected with a public interest" and thus subject to regulation. Property becomes clothed with a public interest, said the Court, "when used in a manner to make it of public consequence, and affect the community at large." If grain elevators might be regulated in the public interest, there could be no question as to the power of the states to regulate railroads and thus that question was considered settled.

Along with the question of the power to regulate went the question as to the limits upon such power. The railroads contended that if the states had power to fix rates they were limited in its exercise to a point that would give the roads an adequate or a reasonable return. They further contended that the question as to what rates were reasonable was a subject for judicial determination rather than one that was to be left to the legislature or to a state railway commission. The United States Supreme Court refused to accept this analysis and said in Munn v. Illinois:

> "In countries where the common law prevails, it has been customary from time immemorial for the legislature to declare what shall be a reasonable compensation under such circumstances . . . we know that this is a power which may be abused; but that is no argument against its existence. For protection against abuses by legislatures the people must resort to the polls, not to the courts."

Ten years later, however (1886), the Supreme Court gave up this principle of judicial self-denial and said, "The power to regulate is not the power to destroy," and that it must not be inferred that "the power of limitation or regulation is itself

[1] 94 U. S. 113.

without limit."[1] While the question of the right of judicial review was not before the court in this case, these remarks foreshadowed the opinion which was to be expressed a few years later.

In the Minnesota rate case,[2] in 1890, the position was taken that "the element of reasonableness both as regards the company and as regards the public, is eminently a question for judicial investigation, requiring due process of law, for its determination." Thus the doctrine laid down fourteen years earlier in Munn v. Illinois was reversed, and legislatures and commissions were denied the final word as to the rates that railroads might charge. This was an unfortunate position for the Court to take. It meant, and has continued to mean, that in all cases of public utility regulation the commission must keep an eye on the Court. Further, as noted in the preceding chapter, the Court has not followed any one formula consistently. Commissions are thus always uncertain of the ground.

The Conflict of State and National Legislative Power. — Congress has power under the federal Constitution to regulate interstate commerce, that is commerce among the states. To quote from Jones:

"It follows that the states have power to regulate commerce *not* among the states, that is, intrastate commerce, unless indeed interstate and intrastate commerce are so mingled together that the supreme authority, the Nation, cannot exercise effective control over interstate commerce without incidental regulation of intrastate commerce. The courts have frequently been called upon to determine the dividing line between interstate and intrastate commerce; and have not always located it at the same place. The early decisions of the courts interpreted the power of the states broadly; the states were permitted to regulate even interstate commerce until Congress saw fit to exert its superior authority. Recent decisions, however, have broadened the scope of federal authority; the federal government has been permitted to regulate even *intrastate* commerce when necessary to the effective regulation of *interstate* commerce."[3]

[1] Stone v. Farmers' Loan & Trust Co., 116 U. S. 307.
[2] C. M. St. P. Ry. Co. v. Minn., 134 U. S. 418.
[3] Jones, *op. cit.*, p. 199.

The National Legislation of 1887. — The Act to Regulate Commerce in 1887 was the first comprehensive statute enacted by Congress for the purpose of regulating interstate railroads. Agitation for federal legislation had been carried on for several years prior to this time. The complaints were largely that rates were too high and that the roads practiced discrimination. A Senate committee reporting in 1886 said: "The paramount evil chargeable against the operation of the transportation system of the United States as now conducted is unjust discrimination between persons, places, commodities, or particular descriptions of traffic."

In addition to the evil of discrimination,

"railroad pools honeycombed the country in the middle eighties, and the public distrusted them from a fear that they would be used to raise and maintain rates. Speculation, manipulation, fraud, and corruption were very common, especially during the eighties when the railroad net was being developed by leaps and bounds. Stockwatering was customary, and resort to it contributed greatly to the popular hostility against the railroads. And, finally, the arrogance of the railroad managers was bitterly resented by the people. The general attitude of the railway executives was that the railway business was a private one which they would run to please themselves; and many held the view, which a few were bold and foolish enough to express, that 'the public be damned.'" [1]

It was inevitable that the national power would be exercised in this matter. The roads traversed in many cases a large number of states and the state legislation was divergent and conflicting. To secure effective regulation, it was necessary that the national government should assume leadership in this matter.

There were twenty-four sections in the act of 1887. Among other things, discrimination was declared to be unlawful, pooling was forbidden, the public posting of rates was provided for, and provision was made for the Interstate Commerce Commission. This was to be a body of five men who were to devote themselves exclusively to the supervisory and administrative work provided for by the other sections of the act.

[1] Jones, *op. cit.*, p. 213.

But the Supreme Court very soon began a series of decisions that greatly crippled the work of the Commission, proving again, if proof were needed, the strong position which property rights occupy in this country. The new legislation that was made imperative by these adverse decisions of the Court was long delayed, seemingly because of the effective control that the railway interests exercised over the United States Senate. Finally, the Hepburn bill was passed in 1906 and this gave to the Commission sufficient power that it again became effective. The Mann-Elkins act of 1910 gave a further extension of power to the Commission.

During the war, the government took over the railroads and operated them for a period of over two years. Preparatory to the return of the roads to private management, the Esch-Cummins Act — the Transportation Act of 1920 — was enacted. This law represents the abandonment of the principle of competition in the railway industry. This principle died hard, but the march of events finally overcame it. New occasions not only teach new duties, but compel their performance. This act definitely regards the roads as public servants and subjects them to extensive regulation by the Interstate Commerce Commission. The setting of rates, the extension of new lines, the abandonment of old ones, the use of the equipment of one road by another are all subject to regulation by the Commission. Further, the roads are requested to form consolidations, and lastly, rates must be adjusted, if possible, to permit a fair return, but one-half of any excess above 6 per cent on the value of their property must be turned over to the government and shall be used in the interest of the transportation system of the country.

PROBLEMS AND EXERCISES

59. What two principles of cost are fundamental to transportation rates? Explain.

60. Enumerate the principal costs which a railroad has to meet. How are these various items of cost affected by, say, a 12 per cent increase in traffic? How would dividends be affected by such an increase in traffic if rates remained as before? Is it possible that dividends can be increased by charging a special low rate for this additional traffic?

61. Transportation charges for many articles have been what the traffic will bear. Is this justifiable?

62. What is the minimum charge that a road must make for any one shipment? Explain.

63. Decreasing cost of operation has been more characteristic of American than of European railroads. How do you account for this?

64. Cite and exemplify three different kinds of discrimination. (*a*) Is discrimination ever to be justified? Discuss. (*b*) Is discrimination prior to 1900 to be attributed to the then overbuilt condition of American railroads?

65. If empty cars are being taken from the East to Minneapolis to be filled with flour, at what rates may the railroads profitably offer to haul freight in them to Minneapolis? May there be social disadvantages in allowing the railroads to carry freight at these low rates? That is, should the national law permit such practice? Discuss.

66. Show that if a railroad runs from A to C through B, it might be to the interest of the shippers at B, if the railroad were allowed to carry freight from A to C at a less rate per ton than is charged for carrying freight from B to C. Give a practical illustration of this problem by substituting the names of cities in the United States for the letters.

67. In the early days of the railroads in the United States a definite effort was made to encourage competition among roads.

(*a*) By what arguments would this position have been defended?

(*b*) Show why competition failed to function as anticipated.

(*c*) Sketch the history of the abandonment of the policy of competition among railroads.

68. Is there a tendency for the regulatory power of the various states over the railroads to be increased, or for that of the national government to be increased? Account for the tendency.

69. Rate wars characterized much of the early history of the American railroads. Account for this in terms of constant and variable costs.

70. Does railroad business tend to be monopolistic in the long run? Explain. Is a monopoly condition better from the standpoint of social welfare than a competitive condition? Discuss.

REFERENCES

The book by Eliot Jones which is referred to several times in the footnotes of this chapter is one of the best books on this subject.

A book of readings by Jones and Vanderblue, *Railroads, Cases and Selections*, 1925, contains excellent illustrative material.

A weekly periodical, *The Railway Age*, gives current information in regard to the various phases of the railway problem.

See also other texts in economics and the economic journals.

CHAPTER XXXVIII

INDUSTRIAL MONOPOLY AND ITS CONTROL

The problem of social control, by legislation, of monopoly in the general field of business has, along with the problem of the control of municipal monopolies and railways, long concerned the American people. Here, too, the central problem is similar to that which is found in the field of public utilities (including railways); namely, the securing of fair prices to consumers. If prices are unduly high, consumers not only suffer directly, but sellers reap large profits which lead to big fortunes that are commonly regarded as being socially disadvantageous. Further, the monopolization that permits high prices also closes the door of opportunity in the field affected to persons who would otherwise enter it.

Monopolization in the field of municipal public utilities has been accepted as inevitable and desirable, and in the railway field rate competition has been given up in favor of public regulation, although roads still compete on the basis of service. But the idea that competition in these fields would best serve the public welfare was given up very reluctantly. Is the attitude toward monopolization in the general field of business to undergo a similar change? Will monopoly be accepted and the prices of products be regulated by government commissions in the case of, say, steel, sugar, oil, meat, or farm machinery?

Whether or not monopolization is to come about in particular industries there is no question that in many lines of enterprise extremely large units have come to be the rule. Further, in certain fields a single large firm may be of outstanding importance. But the large firm may not possess a monopoly. The competition of small firms against it may be very effective. The United States Supreme Court made this point in a recent case involving the International Harvester Company. It held that

mere size is not to be condemned and that neither does size alone mean a state of monopoly. Hence, obviously, a combination or a consolidation of firms does not necessarily mean monopolization.

It is also desirable to note the distinction between what may be called a partial monopoly and a complete monopoly. By a partial monopoly is meant a case in which one firm or a combination of firms dominates the industry in question, and through its control over a large portion of the supply exercises a high degree of control over price, but as by definition it does not have control over all of the supply it does not have a complete monopoly. Such a case is often referred to as an *effective* monopoly. If, for example, one firm should control the production of 75 per cent of the steel, or sugar, or tobacco of the country it would have a large measure of control over the price of the product. The smaller firms might charge the same price as the big one, or a little more or a little less, but their prices could not but be greatly influenced by the price set by the large firm.

All of the cases of monopoly or near-monopoly in the field of industry have resulted from a combination, or consolidation, of firms. Thus the following discussion will be largely devoted to the question of combination.

The period of the marked growth in the number of combinations lies within the years 1887 to 1900. It has been computed that during this time 235 combinations were formed each with a capitalization of $1,000,000 or more, and that the total number had a capitalization of over 5,000 million dollars.[1] It is also estimated that by 1911, before the dissolution of certain combinations by the Supreme Court, the combined capitalization of the big combinations amounted to $6,000,000,000.[2] The years of the most rapid growth of the big combinations were in the late nineties and the first few years of the present century. In the recent period following the World War, several important big combinations have been formed.

[1] E. Jones, *The Trust Problem in the United States*, 1921, p. 39.
[2] Seager, *op. cit.*, p. 471.

Reasons for the Combinations. — The motives that impel men along any line of action such as that under consideration may be very many. Four will be mentioned as significant in respect to the big combinations. The first two of these might be considered together as one, as the profit motive, but even so, they would be listed as two divisions or aspects of the one motive. First, the desire to eliminate destructive competition has been a strong factor in many cases. If the equipment for an industry is very expensive, and if the industry is overbuilt, there is a tendency for competition to be very destructive. The situation may easily take on the character of the rate wars among the railroads in the seventies and eighties, or of the cut-throat competition among city street car lines during the early years of that industry. Lack of full utilization of equipment prompts price cutting on the part of one or more firms; this leads to cuts by the other firms; and thus they all drift toward bankruptcy. The necessity of getting relief from such a situation is apparent. The smaller and less securely established firms will be inclined to listen eagerly to proposals of purchase on the part of the larger firms, and the larger firms will usually be glad to buy. Or, a combination of firms may be proposed, with the larger firms dictating the terms of the amalgamation. In short, the fact that American industrial plants have been almost always in an overbuilt condition has been a potent factor in promoting combinations.

In the second place, combinations may be encouraged, not as just indicated, to check price cutting, but in order to reduce costs and thus permit, or at least make possible, a reduction in price. Indeed, in certain cases, significant savings may be made as a result of a combination. If the freight charges for raw materials or for finished products are relatively large, a combination may save the various firms considerable sums of money by permitting them to divide up the territory among the various firms that are combining, assuming that they are located in different parts of the country. Further, a combination of plants may be better managed than are the individual firms. If one outstanding firm is being managed most successfully, other firms

may the more readily be interested in being joined to it. Then, too, if the equipment is expensive and excessive, combination may be encouraged in order that some of the plants — some of the equipment — may be abandoned.

This would also result in a saving of management expense. Thus in 1887 seventeen sugar companies combined. They had in all twenty refineries, twelve of which were speedily eliminated and later four more. Four refineries thus took the place of twenty, and this evidently resulted in a tremendous saving.

Considerable savings may also be effected in certain cases by forming a vertical combination, as then the various plants in the series of operations will not produce more than is needed to make possible the volume of finished output that it has been decided to produce. No losses will arise on account of the inability of the different plants in the series to sell their products. The combination itself will afford a market for the product of the plants, except of those that produce the "finished product." The coal and ore mines, boat and railroad lines, and iron mills of the United States Steel Corporation are presumably operated more effectively year by year as part of the work of producing steel than if each were selling its product in the open market.

A third factor in promoting the combination of firms in many cases is the desire for bigness on the part of the dominant persons concerned. The enlargement of their enterprises by the absorption of smaller firms will give to such persons additional prestige and an added feeling of importance. This may be a very compelling motive in many cases.

In the fourth place, the profits that may accrue to the promoter of the combination may be sufficient not only to encourage certain persons to undertake the task of effecting a combination, but also to stimulate them to great zeal in the endeavor to reconcile the various interests involved and to bring about a combination. To effect such a union is not by any means an easy task in the usual case. Each of a dozen different firms normally has a capitalization set-up — common

stock, preferred stock, and bonds — which is different from that of the others, not only as to amounts but as to provisions governing the various securities. Or, from another angle, each firm in any group would tend to differ from the others in regard to the nature and value of its assets. Then, too, differences would be found in regard to the prospects for future success. To induce the various parties at interest to agree to a plan of transferring their property to the "combine," and exchanging their securities for securities of the "combine," may be a very difficult task. It may also be necessary after an agreement has been effected to provide a large sum of cash in order to buy the plants of reluctant owners and to provide working capital for the new concern. In short, the promotion of a combination may call for such an array of talent and capital that the persons who are successful in the rôle may be able to exact very high returns for this effort. The promoters and underwriters of the Whiskey Trust are said to have secured $10,700,000 in preferred, and $13,600,000 in common stock in exchange for $3,500,000 in cash. The profits realized depended, of course, on the price at which they sold the stock that they received. This probably amounted to several million dollars.[1] The United States Steel Corporation was formed in 1901 from a union of ten companies. The J. P. Morgan syndicate brought about the combination and received for its services securities to the value of $63,500,000.[2] Evidently the expectation of such enormous profits by promoters must have been an important factor in the formation of many combinations.

The Attitude toward Monopolies. — The prevailing attitude in America toward industrial combinations and monopolies has been one of hostility. Until very recently there has been but little in the way of scientific inquiry as to how combinations have affected our economic life. The common assumption has been that combinations are bad. This has been due to the fact that the traditional attitude in this country has been one of

[1] Seager, *op. cit.*, p. 473.

[2] Report on the Steel Industry, quoted in J. A. Ryan, *Distributive Justice*, 1916, p. 285.

fear toward the big concerns and one of vigorous opposition toward monopolies. Indeed, as indicated earlier, opposition toward monopolies or any contract or combination in restraint of trade is of very long standing among American people and their English forbears. The political demagogue has not been unaware of this situation, and he has at the same time furthered his interests and deepened the opposition toward big business by his denunciation of combinations and trusts. Recently, however, there have been many indications of a saner attitude toward the questions involved, as will be noted at the close of this chapter.

The Early Trusts. — The popular method of combining several firms in the earlier years of the combination movement was that of the trustee device. The first use that was made of this was by the Standard Oil Company in 1879 in connection with several other oil companies. In 1882 the agreement was revised to include forty companies which represented over 90 per cent of the oil refining plants of the country. This agreement provided that the majority stockholders in the various companies were to turn over to nine trustees the stock which they held, and receive in exchange trust certificates from the trustees. The trustees were not to become owners of the stock but were to hold it in trust for the holders of the trust certificates. They had power, however, to exercise the voting rights of the stock and thus they exercised complete control over the companies concerned. Further, the stockholders gave up title to the earnings from their particular companies and instead secured fractional interests in the earnings of the combined companies. But the trustees determined how the money earned should be used — whether it should be paid as dividends on the trust certificates, or used to purchase additional plants, or to extend in some other way the scope of the trust.

The success of the oil trusts led to the formation of other similar trusts. The Cotton Oil Trust was founded in 1884, the Linseed Oil Trust in 1885, and the Whiskey and Sugar trusts in 1887. As a result of the number of the trusts that were formed, the word became so associated with the idea of monopo-

listic combinations that it has continued to be used in this sense, although the trustee form of combination disappeared shortly after it arose.

The Illegality of the Trusts. — These trusts soon became the objects of attack in several of the states. Two significant court decisions were soon made in regard to them. The highest tribunal in the state of New York, the Circuit Court of Appeals, in 1890, declared in a case involving one of the companies in the Sugar Trust that the company in question did not have a legal right to become a party to the trustee agreement. This company was a corporation; it had power to do only those things which the state law prescribed that it might do, and the state had not given permission to corporation directors to surrender their power to another body, such as the trustees in this case. Thus trust agreements by corporations were declared to be illegal in New York.

Two years later, the Ohio State Supreme Court in a case involving the Standard Oil Company declared first, as did the New York court, that a corporation could not surrender its power to trustees, and second, that the companies forming the trust were acting in restraint of trade and therefore in an unlawful manner. These adverse court decisions meant that the trustee form of organization had to be abandoned. The name of trust has, however, as indicated above, continued to be used to designate a monopolistic combination.

Pools. — Some groups of firms sought to secure the advantages of combinations by forming pools or, in other words, agreeing to pool their profits. Under such an agreement there was no inducement to cut prices in order to get business as the various companies shared profits according to a prearranged scheme of distribution which did not depend on the sales of the different companies. Two important pools were the Meat Pool, organized in 1885, and the Wire Nail Pool that was organized in 1895. Pools may be declared illegal under the common law as being in restraint of trade, but whether or not this is done in the case of any given pool, there is no way to compel the various parties to observe such an agreement.

For, since the pool agreement or contract is in restraint of trade, it is not enforceable in the courts. Hence the pool agreement was not as a rule very satisfactory to the parties concerned.

Interlocking Directorates. — Another form of combination is that of interlocking directorates. By electing themselves to the boards of directors of a group of competing companies, a few men can eliminate competition and secure unified action. A combination of this kind depends on the control of a sufficient volume of voting stock to control the election of directors. An illustration of this form of centralization of control was given in Chapter XIII. If an interlocking directorate is in effect a combination in restraint of trade it is, of course, illegal under the common law. As will be indicated presently, such combinations under certain conditions are specifically prohibited by the Clayton Act.

Holding Companies. — The limitation which the corporation laws of most of the states imposed on the trusteeship device has already been noted. It was also, under the early corporation laws, illegal for a corporation to own stock in another corporation. Special legislation had been enacted in certain states to permit this in particular cases. But, generally speaking, one corporation could not own, buy, and sell the stock of other corporations. This legal condition, obviously, prevented the combination of corporations by one securing control of others. One corporation might, of course, sell its property to another and cease to exist. But two or more could not combine and each one maintain its identity. This legal obstacle in the way of the combination of corporations was removed by legislation in the state of New Jersey in 1889 and 1893. It was provided that one corporation might hold the stock of another corporation and exercise the right of ownership. It thus became possible to organize a company merely for the purpose of holding — owning — the stock of other companies. And since corporations organized in New Jersey could do business in other states, that which was properly called a holding company speedily became a favorite form of combination. Other states, not wishing to

lose corporation fees and taxes to New Jersey, soon enacted similar legislation.

The holding company device consists of exchanging the stock of the various companies, or a voting majority of it, for the stock of the holding company. The holding company thus exercises control over the companies whose stock it holds, or in reality owns. This is essentially the same as the trustee device. The only practical difference is that the holding company gives its stock in exchange for the stock of other companies rather than giving trust certificates. But the holding company is legal. Since the New Jersey legislation, there has not been any question of legality so far as the corporation law is concerned. Further, the question of restraint of trade among the combined companies is not in point because the holding company owns the other companies and hence they cannot be said to be in agreement to restrain trade among themselves. The holding company is, however, amenable to the law if it possesses a monopoly of a particular field. This depends on the extent to which the holding company controls the entire industry. But two or more firms however small were guilty of restraint of trade under a trustee agreement.

As was indicated in an earlier chapter,[1] the holding company plan permits an enormous concentration of power, especially if the various subsidiary corporations own a majority of stock in still other corporations. For the holding company itself, but little, if any, money may be needed as its stock is purchased with the stock of the combining companies.

The Sherman Act. — The organization of trusts during the eighties led to antitrust legislation in many of the states and to a national law known as the Sherman Act, which was passed in 1890. The two leading sections of this law are as follows:

> SECTION. 1. Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal. Every person who shall make such a contract or engage in any such combination or conspiracy, shall be deemed guilty of a misdemeanor.

[1] Chapter XIII.

SECTION 2. Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor.

The law perhaps made no addition to the common law as it has prevailed for a very long period of time, but it did give formal legislative sanction to the principle of the common law as it concerns restraint of trade and monopolization. It also provided that triple damages may be collected by anyone who has suffered loss at the hands of a monopoly. It further made it obligatory upon certain officials to prosecute firms that were deemed to have a monopoly, or to be guilty of restraint of trade.

Judicial Interpretation of the Sherman Act. — The Sherman Act was almost a dead letter for several years. Indeed the Supreme Court did not render a decision dissolving a combination in restraint of trade until 1899, and this involved a pooling arrangement and not a close combination. The failure of the law was in part due to the indifference of the administrative officials of the government, but it was also due to a feeling of helplessness that resulted from an early decision by the Supreme Court in reference to the Sherman Act. The Court held in this case, in 1895, that manufacturing was not commerce and thus although a combination of firms had, in the case at issue, monopolized the manufacture of sugar, it did not follow that the commerce in sugar had been monopolized.[1] Following this decision, President Cleveland, for example, took the position that the ruling of the Supreme Court made the national legislation ineffective and that the people must look to the states for relief.

The Court did rule against combinations in the transportation business, under the Sherman Act, and also against trade unions in certain cases, but manufacturing concerns were for a decade free from the restraints of the statute. But under the "trust busting" program of President Roosevelt, who became President in 1901, the Sherman Act was made an effective weapon against monopolistic combinations. Not only did the number

[1] E. C. Knight Sugar Refining Co. v. United States, 156 U. S. 1 (1895).

of cases under the act increase, but new legislation was enacted to facilitate the handling of antitrust cases by the courts.

Three dissolution decisions by the United States Supreme Court will be mentioned. In 1904, in the Northern Securities Company case,[1] it was held that the holding company organized in New Jersey to hold the stock of the Northern Pacific and the Great Northern Railway companies was illegal and must be dissolved. The significant point was that the company had attempted a monopolization of the railway business in the northwestern part of the United States.

In 1911 the Standard Oil Company, which had become a holding company under the law of New Jersey, was ordered dissolved[2] and in the same year dissolution was ordered in the case of the Tobacco Trust.[3] One point of great significance in these two cases was that the Supreme Court held that the Sherman Act must be interpreted by the rule of reason. That is, although the act condemned all combinations in restraint of trade, the Court held in these cases that only unreasonable restraint of trade was amenable to the law. This was the principle that had prevailed under the common law, but in the earlier decisions of the Court it had been held that the Sherman law must be interpreted strictly as applying to every restraint of trade. This new judicial attitude toward the Sherman Act reflected a change in the attitude of the public toward big business. This change of attitude had also been indicated by President Roosevelt's distinction between good trusts and bad trusts. The rule of reason did not, however, save the Standard Oil Company nor the Tobacco Trust from dissolution. In the Standard Oil case the Court took cognizance of the methods that had been used to build up a monopoly and criticized them vigorously.

It is interesting to note that the Supreme Court early refused to apply the Sherman Act in the case of manufacturing; and in the transportation field, for example, in the Trans-Missouri Freight case,[4] in 1897, it insisted that every restraint of trade in transportation, whether reasonable or not, was con-

[1] 193 U. S. 197. [2] 221 U. S. 1. [3] 221 U. S. 106. [4] 166 U. S. 290.

trary to the law. But by 1911 it had taken a different position in regard to each of these two points. It had come to hold that manufacturing combinations were amenable to the law, but that the law did not apply except where there were unreasonable restraints of trade, that is, where the restraint seemed to the judges to be unreasonable. This again illustrates the power of the judiciary in our government over legislation that affects our economic life. The courts by the interpretation of statutes to a considerable degree make them what they wish them to be. This means that the attitude of judges — their social, economic and political philosophy — determines in considerable degree the policies that the people of the country may adopt in respect to the economic system.

The Bureau of Corporations. — President Roosevelt in his first message to Congress insisted that facts were needed in order to deal satisfactorily with the trust problem, and he indicated that there was also need for publicity. In his second message he again insisted on the necessity for publicity and added that "publicity can do no harm to the honest corporation; and we need not be over-tender about sparing the dishonest corporation."[1]

In line with the President's recommendation, Congress in 1903 provided for a Bureau of Corporations that was to investigate the affairs of corporations that were engaged in interstate or foreign commerce. The bureau was discontinued but its work was extended and enlarged by the law of 1914 that provided for the Federal Trade Commission.

The Federal Trade Commission. — During the political campaign of 1912, Woodrow Wilson gave a great deal of attention to the trust problem, and upon his inauguration as President in 1913 he advocated additional legislation. One of the outstanding achievements of his administration was the Federal Trade Commission Act of 1914. This Commission, as just noted, took over the work of the Bureau of Corporations under an extension of scope and power. The government policy thus far had been largely one of suppression of monopoly; it

[1] Patterson and Scholz, *ibid.*, p. 154.

now began an attempt to prevent monopolies from arising. The experience thus far had shown that reprehensible business tactics — unfair competition — had constituted an important factor in the elimination of competitors and in the effecting of monopoly. For example, local price discriminations to stifle competition, misrepresentation of goods of competitors, infringement upon trade marks, bribing the employees of competitors, and the establishment of spy systems to report upon a competitor's business, had in many cases marked the road to the business success of a particular firm or trust. With an eye upon such practices, Congress, in providing for the Federal Trade Commission, declared that unfair means of competition are unlawful, and instructed the Federal Trade Commission to prevent the practice of such methods. The law did not make any specifications as to what is unfair competition, leaving the Commission to exercise discretion in this regard.

The Commission has the power to investigate the business of any firm engaged in interstate commerce, and has the authority to compel business men to produce the records of their firms and to give testimony. Further, the Commission is required, when requested by the Department of Justice, to recommend a plan of conduct that will bring within the law the conduct of a corporation alleged to be violating the federal antitrust acts. It also has the privilege of recommending desired legislation to Congress.

One of the significant and typical practices of the Commission is known as the "trade practice submittal." In reference to this the Commission says in its report for 1923:[1]

"From time to time the commission is approached by groups of business men representing an entire industry and seeking the assistance of the commission in the elimination from their industry of practices found to be unfair and harmful but which the industry is unable by itself to eliminate. The commission has lent its assistance in these situations and has called the industry together in gatherings which have been termed 'trade-practice submittals.' These submittals have been held in the following industries: Ink, celluloid, knit goods, paper, oil,

[1] Page 17, cited in *Trade Associations* by the National Industrial Conference Board, 1925, p. 55.

used typewriters, creamery, hosiery, guarantee against decline, macaroni, silverware, gold knives, watch cases.

"At these submittals the objectionable practices are frankly discussed and resolutions usually adopted by the industry looking to their elimination. These resolutions are considered by the industry as binding upon it and are received by the commission as informative as to conditions in the particular industry and the views of the trade thereon."

The Commission is composed of five men appointed by the President to serve for a period of seven years. The compensation is $10,000 a year. Not more than three of the five men may belong to the same political party. There seems to be no doubt that the Commission is performing a very important work. Its constant round of investigations, reports, and recommendations is a very salutary influence upon the conduct of business affairs. Further, if "unfair competition" is discovered as a result of an investigation which includes a hearing of the accused, the Commission issues a restraining order to the offender. If the order is not obeyed, the Commission may ask the federal courts to enforce it. The courts then assume jurisdiction and may uphold the Commission and compel the performance that it has suggested, or it may reverse its findings.

The Clayton Act. — In 1914 Congress also passed the Clayton Act. This was designed to be a comprehensive antitrust measure supplementing the Sherman Act. It specifically prohibited certain practices that were perhaps already prohibited by the general language of the Sherman Act; namely, local price discrimination; tying contracts; holding companies when the effect is substantially to lessen competition; and interlocking directorates, other than those in banks and common carriers, if such corporations are or have been competitors. The courts have been somewhat reluctant to permit the prohibitions of the Clayton Act to extend beyond those of the Sherman Act. But they have in certain cases held that the scope of the Clayton Act is more extensive than is that of the earlier law. Perhaps the most significant features of the Clayton Act are those provisions making the legal proceedings against

an offender less difficult than had been the case under the Sherman Act.[1]

The Webb-Pomerene Act. — Another evidence of a somewhat different attitude toward large combinations is found in the Webb-Pomerene Act of 1918. This law specifically exempts from the Sherman Act associations that are organized "for the sole purpose of engaging in foreign trade and actually engaged solely in such export trade." Such associations must file annual reports with the Federal Trade Commission. A number of such associations have been formed representing several thousand firms. The formation of such associations makes it possible in many cases to secure enough business to permit the development of foreign trade facilities, and also makes possible the distribution of the cost of the enterprise over the many firms that compose the association. As a result many firms have engaged in foreign trade that would otherwise not have been able to do so.

The Steel Case. — The decision of the Supreme Court in 1920 of the antitrust suit against the United States Steel Corporation[2] is especially worthy of note in this discussion. The suit was begun in 1911 and by 1920 the company had discontinued the monopolistic policy that had been complained of at the time the suit was filed. The Court held that it had no adequate grounds for ordering the dissolution of the corporation, and it added that to do so would involve "a risk of injury to the public interests including a material disturbance of and it may be a serious detriment to the foreign trade." "Thus," says Seager, "did the rule of reason of 1911 become the rule of business expediency in 1920."[3] In other words, the Court indicated an attitude of mind toward the question of monopoly that was markedly different from that which had prevailed thirty years earlier.

The Present Trend. — The preceding discussion indicates the development of a tolerant attitude toward large combinations during the past two decades. Monopoly is not condoned,

[1] Compare Patterson and Scholz, *ibid.*, p. 159.
[2] 251 U. S. 417.
[3] *Op. cit.*, p. 490.

but size alone is not so disturbing as formerly. Further, the prevention of unfair practices through the operation of the Federal Trade Commission is a significant aspect of the present trend in the attitude toward this problem.

It is interesting in this connection to note the attitude of the National Secretary of Labor as revealed in his annual report for the year 1927.

"I have observed not a few situations in which it seemed to me that consolidation or combinations in the field of industry would be of much benefit to the general public and to those who have been directly concerned in several unfavorable industrial situations. In other words, it has seemed to me more than once during the past few years that the spirit and intent of antitrust principles could have been retained, and, yet, that adjustments could have been made which would have relieved a tense industrial situation. . . .

"For example, I learn that leaders in cotton textiles, whose motives cannot be questioned, believe that the industry might give greater service to all concerned in the way of production, earnings, and steadier employment if permitted certain amalgamations not now allowed under the antitrust law.

"The present deplorable conditions in the bituminous coal-mining industry in this country, overdeveloped and overmanned as it is, unprofitable in the main part for most operators and furnishing but intermittent employment to the miners, could be improved by consolidation were it not for fear that indictments could lie under the antitrust laws. With consolidation there would be ample competition. Many plans have been suggested in the bituminous-coal situation looking to some forms of relief, among them the establishment of joint selling agencies by which coal in certain territory might be marketed jointly, thus giving assurance of steadier employment and more stable output, with sufficient car supply and other advantages which are now lacking. But it is said that the plans suggested along this line are open violation of the law against the formation of monopolies."[1]

The size of our country and the inherent limitations on the size of an industrial undertaking makes it difficult for one firm to obtain a monopoly in many, at least, of the important fields of manufacturing. But if monopolization did take place in some field and if it should appear that monopoly is more economical than competition would be, as in the case of the

[1] P. 147.

municipal monopolies, the logical conclusion would be that the monopoly should be permanent and that the Federal Trade Commission, or some similar body, should regulate the prices to be charged. The alternative to this would be that the company must be broken up and competition restored. But if monopoly should be much more economical than competition in a certain case, it would seem to be foolish to insist upon having competition, rather than monopoly subject to price regulation by the government. It may indeed be true that price regulation in a few of the important lines of industry, comparable to the regulation of railway rates, will be the logical development of present tendencies in American industry.[1]

Super-power Combinations. — The suggestion in the previous paragraph is likely to be realized in the super-power electrical industry. The development of electrical power generating plants at the coal mines and at waterfalls has been greatly augmented recently and the area over which electricity is being sold has been greatly extended. There is obviously no possibility of effective competition in the super-power industry. Competition is as much out of the question as in the case of railroads or city street car lines. Hence, regulation of the price of electric current and the conditions of service, by public commissions, is inevitable. This has already been undertaken in some states. But the power lines do not confine themselves to state boundaries. This business is interstate in character and thus the logical form of regulation is to be found in the national government. Further, the Supreme Court has held recently in a Rhode Island case that the utility commission in one state has no authority over the rates paid for electricity produced in another state and carried over the border. Thus if there is to be regulation in such a case it must come from the National government. A national power board has already been provided to deal with problems affecting power development in rivers that flow between two or more states. It is to be expected that its scope will finally be extended so that it or some other governmental agency can deal comprehensively

[1] See discussion in Chapter LXI.

with the problem of fair rates and fair service in the sale of electric current by interstate companies.

PROBLEMS AND EXERCISES

71. Trace the use of the word "trust" in respect to monopolistic combinations.

72. Assuming it to be legal, outline a plan by which five cement plants could be combined by means of a "trustee" agreement.

73. Same as No. 72 for a holding company.

74. What is the essential difference between an early trust and a holding company?

75. Give an original illustration of a case of "restraint of trade."

76. Define common law; statutory law. Illustrate each.

77. What is meant by the "rule of reason" in respect to the Supreme Court? Sketch its history.

78. (*a*) Under what conditions would it be socially advisable to have a monopolistic combination in the glass industry? Why?

(*b*) Would regulation be advisable then? Why?

79. "The Federal Trade Commission represents a great step forward." What reasons can be given to support this statement?

80. (*a*) Give an illustration of the power of our courts to determine the economic arrangements in our society. (*b*) Account for the fact that the courts have this power with us. Contrast this situation with that which prevails in England.

81. Give three illustrations of a change in attitude in this country toward monopolies.

REFERENCES

Industrial Combinations and Public Policy, by M. W. Watkins, 1927, gives a good treatment of this subject. The book by Jones noted in a footnote is the most comprehensive of the general works in this field.

A. C. Pigou in *The Economics of Welfare*, 2d ed., London, 1924, gives an admirable account of the significance of monopoly. See also his *Wealth and Welfare*, London, 1912.

CHAPTER XXXIX

TRADE ASSOCIATIONS [1]

Trade Associations. — A trade association represents another attempt at the autonomous control of economic activity of a group of individual firms. It differs from a monopolistic combination in that the individual firms participating do not give up their identity and the association as such does not engage in business. In other words, the trade association is not a firm. It is a group of firms each of which carries on its business independently of the others except as the rules of the association may limit their activities. Further, the firms in the trade association are all engaged in the same industry or trade. Thus an organization such as the National Association of Manufacturers or a chamber of commerce is not a trade association.

Number of Trade Associations. — No one knows how many trade associations there are in the United States. As just indicated, not all associations of business men are trade associations, and it is difficult in many cases to decide whether an association is or is not properly to be called a trade association. But it seems safe to say that there were about 850 organizations in the United States in 1923 that were clearly national or interstate trade associations, and that there were many more associations that performed many of the functions of trade associations.[2] A list of associations grouped according to the year of organization in *Trade Associations* begins with the Writing Paper Manufacturers' Association formed in 1861, and includes associations having to do with cotton, jewelry, silk,

[1] The National Industrial Conference Board made an exhaustive study of trade associations and published its findings in a book issued in 1925 entitled *Trade Associations: Their Economic Significance and Legal Status*. This book is drawn upon heavily for the material of this chapter.

[2] *Trade Associations*, p. 325.

liquor, bill posters, rubber, pipes, sauerkraut, baby carriages, caskets, and seemingly every other article of commerce or type of business.[1] The field of associations seems to be coextensive with that of business enterprise.

Functions of the Trade Association. — Obviously, the purpose of the trade association is to serve the interests of the members thereof. The interests to be served may be in part social and intellectual, but primarily an association is formed to further the business interests of its members. An association may carry on advertising projects in the interests of all of the members as is done by the cement association, the laundrymen's association, and many others. It may also provide for an exchange of information among the members relative to the technique of business operations; it may conduct research work; provide for coöperative insurance; or provide services for the collection of debts. These forms of activity are perhaps conducive to the general social welfare as well as to the welfare of the individual members making up the association.

Further, a trade association may, through the dissemination of information in regard to the market and in regard to the volume of production and sales by the various member firms, make it possible for the respective members to conduct their plants in a more intelligent manner than would otherwise be the case. To phrase this differently, the competitive process is often very wasteful as a result of the lack of adequate information on the part of competitors. The association by providing market and production information may thus prevent some of the loss that inheres in a system of competitive production. Also the competitive struggle often leads to ruinous price cutting that culminates in the bankruptcy of some of the firms or in the amalgamation of some or all of them into a monopolistic combination. An association may prevent such price wars and may thus in this way prevent some of the waste of competition. But an association may also attempt to control the price of the product of the members with a view, of course, to maintaining a higher price than would otherwise prevail.

[1] *Trade Associations*, p. 327.

Or it may seek to exclude non-members from the market, and also by other devices seek to maintain a monopolistic position for the members of the association. If an association does engage in practices that are monopolistic — that are in restraint of trade, or obstructive to the free flow of commerce — it is amenable to the law, as would be inferred from the discussion in the preceding chapter.

The Problem. — The fundamental problem in respect to the trade association is fundamentally the same as that in respect to monopoly, or railways, or municipal public utilities, namely, what arrangements relative to the trade association will best promote the common welfare. But the immediate problem is slightly more narrow; namely, is a given association acting within the law, or, in view of the law, would the judges in the courts deem its action to be reasonable? However, it is to the broader problem that we must look in the long run, for our attitude relative to it will determine the character of our laws and ultimately the decisions of the judges. The task is to chart a course for the trade association that will utilize it in the promotion of social welfare. It seems safe to say that this is being done. Indeed, in so far as we are wise, this is being done in regard to all phases of our economic system. As conditions change, new arrangements are made which, if the electorate have acted wisely, will, under the altered circumstances, promote the general welfare. In respect to trade associations, the same agencies that were noted in the preceding chapter are involved in the charting of this course. These include the Federal Trade Commission, the administrative branches of the government, Congress, and the courts, assisted by the general public attitude as to what is or is not desirable. The limitations that have been placed upon the acts of trade associations will be in part indicated in the following discussion. The first four points to be mentioned concern practices that have been unequivocally prohibited by law.

Unification in Selling. — A case of unified selling by the members of a coal association came before the courts in 1902. Under the agreement in question the members of the association

were to sell only to one agency. This meant, of course, the absolute prohibition of competition among the members of the association, and was thus clearly in restraint of trade. The court ordered the dissolution of this company. Many other cases could be cited in which similar attempts of combinations to prevent price competition were considered by the courts, and the selling agencies dissolved, or the customer granted redress in damages. In a case from Portland, Oregon, a contractor was awarded triple damages under the Sherman Act because of being unable to buy lumber except from a single sales agency that represented every lumber manufacturer that had access to the Portland market.[1]

Exclusion from Markets. — Another practice that the struggle for profits almost necessarily suggests to the members of a trade association is discrimination against non-members. This may take many forms. An agreement may be made not to deal with firms that cut prices below the association's price, or a secondary boycott may be instituted — members of an association may refuse to buy from or sell to any party who deals with a non-association member. Again, the method used may consist of exclusion from the market by consent, that is, the members of an association may divide a given territory among them, assigning to each a given district. Further, bribery may be resorted to, or inducements offered to persons not to trade with the obnoxious party.[2]

Efforts to exclude new firms from a share in the business in which members of an association engage are not normally exerted against firms that are primarily engaged in the business in question. But should a firm extend the scope of its business by taking up a new line of work, the firms with which the new work competes may actively seek to curtail its activity. In regard to this, the following quotation is apt:

> "The great majority of the cases that have arisen involving exclusion from the market have sprung from united efforts to expel manufacturers from the jobbing trade, jobbers from the retail trade, retailers from the jobbing trade, and so on. There appears to be a strong feel-

[1] *Trade Associations*, p. 62. [2] *Trade Associations*, p. 71.

ing among large groups of business men that the boundaries of conventional business organization, particularly on the marketing side, are sacrosanct — that the *status quo* must be maintained at all hazards." [1]

All practices of excluding competitors from a market are condemned by the courts. In a case involving the National Window Glass Jobbers Association it was shown that the members had mutually divided the market into non-competitive areas, and treble damages were assessed against the organization. The Philadelphia Tile Dealers Association instituted a boycott against manufacturers who sold to other firms than the members of the association, and as a result, the members principally responsible for this practice were held to be criminally liable and fines and sentences were imposed. In short, any curtailment of market facilities to competitors is in restraint of trade and therefore illegal.

Curtailment of Production. — The curtailment of production is only another method of maintaining high prices such as is contemplated by a unified selling agency or by excluding competitors from the market. Phrased differently, any agreement to restrain production is in restraint of trade. It obstructs the free flow of commerce and is hence illegal. Individual business men may, of course, curtail production and one may advise another to reduce his output, but a group of persons may not mutually agree to do this without being outside the law. The question as to when the mutual exchange of opinion by competitors, as to the course of business and as to the desirability of altering a given flow of output, should be construed as crossing the line into the forbidden field of agreement to restrict output is a question for the adjudication of the courts, in the various cases that arise. But the courts usually hold such action is legal unless it is clearly shown that the persons concerned have mutually agreed to restrict the output of their respective plants with a view to their mutual profit. Any agreement, formal or informal, to this end is illegal, but the mutual exchange of opinion is not.

Price Control. — Similarly to the above indirect attempts

[1] *Trade Associations*, p. 70.

at price control, a concerted attempt by the members of an association to fix a price at which they will sell is an obstruction to the free flow of commerce and hence is illegal. The central feature of our system of private property, as so frequently emphasized in this book, is the pricing mechanism. As prices rise and fall, business men are encouraged to enter or to leave certain fields. And further, as competition forces price down to cost, it becomes less possible for certain groups to profit to the disadvantage of other groups. We must have either free competitive pricing or price regulation by government authority, as has been frequently emphasized in the two preceding chapters. Hence, since price regulation has not been provided for in the general field of business, there is universal insistence that monopolistic combinations or trade associations with monopolistic powers shall not interfere with free competitive pricing.

But the first thing that the members of an association normally think of is the restriction of price competition. To quote again from the book already referred to:

"There is no other activity for which trade organizations have been so frequently cited before the courts. It formed the basis of the first recorded proceeding under the Sherman Act, and prosecutions for price manipulation are pending against trade associations today. In a long series of decisions, the courts have condemned a wide variety of devices designed to maintain or enhance prices. Whether in the form of a simple agreement to abide by a stipulated scale of prices, or in the form of an elaborate mechanism of licenses, graduated royalties and penalties, arrangements of this character have been held illegal. Moreover, the absolute prohibitions of the law in this matter have given the quest for price-fixing activity special prominence in the anti-trust investigations of the Department of Justice. The first line of attack, in practice, has been directed toward the ascertainment of whether there has been any undertaking, recorded or unrecorded, to observe uniform prices. If such an undertaking is established, all else becomes secondary." [1]

Further, in addition to price agreement, understanding or agreement as to the computation of certain elements that go to make up the final price are also in restraint of trade. Among

[1] *Ibid.*, p. 82, citations to cases given therein.

such agreements are those that "relate to the fixation of a uniform percentage of profit over manufacturing cost or purchase price, the adoption of uniform cost entries for overhead, the substitution of an arbitrary charge for actual expense incurred with respect to some productive process or incidental service. But the possible modes of restraint may, of course, be as varied as the elements which make up the price." [1]

The work of trade associations has concerned the matter of price so exclusively in many cases that they have been known as "open-price associations." Interesting questions have arisen as to just how far a trade association, or an open price association, may go in its price policy and stay within the law. In the Hardwood Lumber case and in the Linseed Oil case the work of the associations in respect to their price policies was condemned by the Supreme Court, but a little later in the Maple Flooring case and in the Cement case somewhat different practices were approved by the Court.

In the first two of these cases the rules of the respective associations called for elaborate reports in regard to sales, prices, and names of customers. These data were compiled and distributed to each of the members of the association. This was regarded by the court as evidence of a fundamental purpose to secure harmonious action in regard to prices and hence as an attempt to restrain trade. Further, in the Hardwood case there was evidence of discussion and communication as to current prices and also evidence that statements were issued by the central office as to the prices that should prevail.

In the two other cases referred to, the Maple Flooring and the Cement case, the work of the associations in this respect consisted of assembling data from members in regard to the volume of product that had been produced, and the prices received. The information concerned only past transactions. Further, these two associations did not give out information as to the identity of the members in respect to the data distributed, except in respect to sales of cement on job contracts. Tabulations were made without any identification of the members

[1] *Ibid.*, p. 83.

supplying the different data. Also, the data assembled by these associations were not considered as confidential information as was true in the Linseed Oil case. Finally, in the Linseed Oil Association heavy penalties were imposed on members who failed to give information or failed to adhere to the prices and terms quoted. But in the Cement and in the Maple Flooring associations "the activities of the association with the exception of the regulation of specific job contracts of cement were conducted entirely through voluntary cooperation." The work of these two associations, as stated above, was approved by the Supreme Court.

These two cases indicate that trade associations may exercise rather broad powers in regard to the prices of products. To summarize the last paragraph of the decision of the court in the Maple Flooring case, an association may assemble data for the information of members as to the volume of production, stock on hand, prices received, and cost of production, and the members may "meet and discuss such information and statistics without, however, reaching or attempting to reach any agreement or any concerted action with respect to prices or production or restraining competition," and not be guilty of an "unlawful restraint of commerce."

Lawful Activities. — The above discussion refers principally to practice in which trade associations may not lawfully engage. But there are many activities, as indicated in the introduction to this chapter and in the preceding paragraph, in which they may engage. In general, a trade association may perform any business service to its members, so long as it does not unreasonably restrain trade. Trade associations often act as a clearing house for the exchange of patents of the members. This results when the various members hold minor patents and find it advisable to make them mutually available. Trade associations also serve their members in the interchange of credit information relative to their customers. But, as in the case of price data, there must not be agreement as to policies that will constitute restraint of trade.

In the matter of standardization of products, trade associa-

tions have done very significant work. The importance of standardization was discussed earlier.[1] That there should be only a limited degree of variation in the sizes and designs of many articles such as bolts, electric light bulbs, automobile tires, and parts of machinery, is obvious. A high degree of standardization not only results in greater convenience and economy to consumers, but reduces the cost both of manufacturing and of retailing. The drafting of standards in regard to quality is also an important social service that many trade associations have undertaken. This tends to eliminate from production articles of inferior quality, but it does not prevent the production of articles of superior quality, as such quality standards specify only the minima that must be maintained. Standardization in regard to measure is likewise important. In an investigation of the lumber industry, for example, there were found to be thirty-two different thicknesses of a "one-inch" board in current use. Many of the trade associations have taken steps to correct such situations by setting up certain standard measures.

Trade associations frequently serve as an agency for research projects of various sorts. Many bureaus and laboratories have recently been established to carry on such work. An association makes it possible to secure highly trained experts — "whether economists, psychologists, and accountants for commercial research, or chemists, physicists, and engineers for technical research." The gains from such research accrue not alone to the firms directly concerned but to the general public as well. One illustration of such projects is found in the arrangements recently made by which the Portland Cement Association is to furnish three chemists and three engineers to work in coöperation with the Bureau of Standards of the United States Government in an investigation of all phases of cement manufacturing processes and the economic uses of concrete.[2]

Trade associations often adopt a common trade name for the products of the various members, which is used as a label

[1] Chapter XVI, "Industrial Management."

[2] *Trade Associations*, p. 221.

upon the goods which are produced by the various individual firms. If this label indicates merely that the individual producer is a member of the association, and that he has conformed to certain minima standards prescribed by the association, that use of the label seems to be socially desirable and not illegal as being in restraint of trade. But if the use of a common label means that the products of all the various firms tend to become identically the same, the implication is that price competition will thereby be destroyed, and thus the use of the label would be held by the courts to be in restraint of trade and, therefore, illegal.

In the development of standards of business conduct the trade associations have a very legitimate part to play in our economic society. A group of men by setting up for themselves high standards of conduct and by mutually pledging themselves to observe these may easily raise the normal level of their competitive activity to the great advantage of the general public. To this end trade associations are assisted by the Federal Trade Commission in, for one way, the "trade practice submittals" to which reference was made in the preceding chapter. But, again, there is possibility of restraint of trade in the establishment of standards of conduct, or codes of business ethics, for the rules of ethical conduct may prescribe such brotherly treatment for the various firms that competition is thereby unduly restrained. Such rules would, of course, be illegal.

All rules that affect business conduct restrict competition somewhat, as they curtail the activity of the individual firm. Even rules that one shall not misrepresent the quality of his product, nor refer slightingly to a competitor's wares, restrict competition. But, as is suggested by these illustrations, not all restrictive rules are held to restrain trade unlawfully. The rule of reason is applied. If the court regards the restrictions as being *reasonable* they are not unlawful. In other words, if the court believes that the rules are in the interest of the general social welfare it regards them as reasonable — as lawful. In such a case, the rules are said to regulate competition rather than restrain it.

A case that illustrates the effect of rules of conduct upon the competition of business men is found in the paint trade. We quote from *Trade Associations* in regard to this,

"The Paint Manufacturers' Association of the United States requires that every manufacturer, as a condition of membership, should sign what is known as a non-exchange agreement.[1] Through this agreement he pledges himself and his staff not to accept any paints of a rival manufacturer, member or non-member, by way of exchange in filling an order for goods from any dealer. In other words, each of the associated paint manufacturers agrees that in selling his products he will make no concessions, or allowances, for goods in dealers' hands other than his own products. This arrangement was designed to eliminate an alleged evil which was claimed to be imposing a serious drain upon the profits of all the manufacturers: namely, the expense and vexation of opening new 'accounts' of a temporary character. According to the recent year books of the association, the agreement has worked satisfactorily to minimize this loss from the frequent shifting of dealer patronage. Does it tend to interfere unduly with the free operation of competitive forces in the paint industry? It may be argued that it erects an artificial barrier against the encroachment by a growing and aggressive manufacturer upon the sales domain of his competitors. Since dealers often prefer to carry, and are frequently permitted to carry, only a single line of such products, it becomes difficult, under the agreement, to dislodge established trade relationships. On the other hand, it may very reasonably be contended that on the whole the rule is beneficial — not only because it serves to discourage meaningless shifting of patronage, but because it tends to eliminate the vicious less-than-cost sales of displaced paint, without hampering either price competition or quality competition in the sale of fresh paint. In this view, the non-exchange agreement may be regarded simply as a regulation of a minor feature of service competition, not unlike the standard practice rules adopted by the Rubber Association of America relative to the adjustment of claims for defective tires." [2]

This agreement has been in operation for many years and has not been attacked in the courts. Perhaps most judges would consider that it is socially beneficial and, therefore, a reasonable

[1] See *Year Book*, Paint Manufacturers of United States, Philadelphia, 1924, pp. 6–8, 47–49. This agreement has also been adopted by the National Varnish Manufacturers' Association and has been made mutual between the two associations.

[2] See *Rubber Association Activities During 1921*, Rubber Association of America, Dec. 1922. *Trade Associations*, p. 201.

interference with competitive activity. Certainly, it is restrictive. It is thus another illustration, especially if it continues to be unquestioned in the courts, of our disposition to subject competitive activity to social control. More and more the principle of control is applied. The "natural" economic forces are to an increasing degree limited in their operation by rules that presumably augment the contribution which the economic system makes to the general social welfare.

Commercial Arbitration. — Disputes inevitably arise between buyers and sellers in regard to the terms of the contract which they have made and as to its fulfillment. The courts are the final arbiters in such matters, but for a very long time certain groups of business men have had machinery of their own for the settlement of such cases. This consists of a non-official "judge," or a group of "judges," who hears the stories of the men concerned and renders a decision. This is called *commercial arbitration.*

The New York Chamber of Commerce has had machinery of this nature for over a century, and recently the practice has been greatly extended. The promptness with which cases may thus be settled and the small amount of expense involved, as compared with trials at law, make this procedure very desirable. This work is conducted most satisfactorily when the "judges," or arbitrators, are familiar with the business in which the dispute has arisen. Hence, trade associations are the logical channels in which to extend the practice of commercial arbitration.

The Silk Association of America has had its arbitration committee engaged at the task of settling disputes since 1898. During the twenty-five years ending in 1923, 158 cases had been decided, 13 of which were in 1923. In the annual reports of the association a summary of the cases is given, including the award made, and thus a body of precedents is being built up to guide the manufacturers and merchants of the silk trade in their dealings with each other.[1]

Within recent years many associations have provided for the arbitration of disputes. Some associations, for example, the

[1] *Ibid.*, p. 281.

National American Wholesale Lumber Associations, go so far as to refuse to admit new members unless an agreement is signed that all contested cases, with certain exceptions, will be submitted to arbitration rather than taken to the courts. And, incidentally, in several states, including New York, the decisions of such arbitration tribunals are as binding as are the decisions of the courts.

The standards that are thus being built up cannot fail to reduce the number of disputes as all of the members of the trade will come to have the same notions as to what is right or wrong in regard to the various aspects of the business.

Indeed, the decisions of the arbitrators in any line of enterprise, if they are consistent, tend to prevent friction among the parties concerned. There comes to be built up a *standard practice* — a code of conduct — a common agreement as to what is right and wrong. Hence, the cause for disputes is largely removed. Each person concerned comes to know the "law," and thus to know, without having a judge or an arbitrator tell him, what is the *standard practice* — what is right — in any case. It is only as novel circumstances arise that there will be differences of opinion as to what is right. In short, arbitration tends to destroy the need for arbitration. The members of the New York Stock Exchange, for example, transact 50 billion dollars of business each year with but only a very few disputes and thus far not a single lawsuit. The practice has become so highly standardized through the work of the arbitration committee that there is but little opportunity for any question to arise as to the proper conduct of members of this group. The rules are understood — the law is plain — and hence disputes seldom arise.

This result also tends to be realized if cases are settled in the law courts. But under commercial arbitration many cases of dispute are passed upon and decisions in regard to them are made that would be compromised by the parties, or not contested if the only alternative were litigation in the courts. Thus commercial arbitration by facilitating the settlement of disputes results in the accumulating of more data in regard to good

practice in the trade than would be the case under court procedure. And, to repeat, the accumulation of this data tends to prevent disputes from arising subsequently. This discussion has an interesting application to agreement between trade unions and employers, as will be noted in a later chapter.

Conclusion. — Trade associations cut into the competitive activity of men. They make our society a less spontaneous and automatic system of individual activity than it would otherwise be. This does not mean, however, that trade associations are undesirable, for unrestrained individual activity in business is in no way sacrosanct, despite the statements of many men to the contrary. Unregulated individual activity leads to waste in many forms. Plants are often unnecessarily duplicated; price cutting frequently disorganizes an industry; and the competitive struggle is often conducted on a very low ethical plane. Trade associations tend to correct such abuses. But they need to be carefully hedged about lest they lay the general public under tribute to the aggrandizement of the members of the associations. They are, as indicated in Chapter IV, something of a recrudescence of the medieval guild. It is possible that they may restore to our economic life an added measure of those ennobling attitudes of the guildsmen which have been somewhat in abeyance during the past two hundred years.

PROBLEMS AND EXERCISES

82. What is said to be the fundamental problem in respect to trade associations? The immediate problem? How are these two related?

83. Illustrate the point in regard to making adjustments in respect to the common welfare by reference to our banking system.

84. Show that the four illegal practices of associations that are described separately are in effect the same.

85. Distinguish between the Hardwood Lumber case and the Maple Flooring case.

86. What is your judgment in regard to the social advisability of the non-exchange rule of the paint association?

87. The International Monumental Granite Producers' Association has as part of its "code" that in bidding on a job each member may

have but one bid. Discuss the merits of this rule. Do you believe that such a rule would restrain trade unreasonably?

88. "Economic *laws* are fundamental. They cannot be repealed by legislatures." Discuss.

89. "Economic forces should be left as they naturally are. Man cannot improve upon nature." Discuss.

90. Discuss the merits of commercial arbitration. Is this used in your community?

REFERENCES

The book published by the National Industrial Conference Board, to which very frequent references were made in this chapter, is the best work on this subject. *Open Price Associations*, 1923, by M. N. Nelson, gives a splendid account of this phase of the work of trade associations.

See also current magazines and journals.

CHAPTER XL

GOVERNMENT OWNERSHIP

The problem which has been discussed in the three preceding chapters raises the question of the advisability of government ownership in the lines of industry where monopolization is preferable to competitive enterprise. If monopoly is to be sanctioned the government must at least regulate the prices to be charged and set standards for the service that is to be rendered. Many persons argue that if the government must go this far, it should take a further step and own and operate the industries in question.

The problem of government ownership in this field also raises the question as to the extension of government ownership to lines of enterprises in which competitive conditions prevail, and this in turn leads to the question as to the advisability of government ownership and control as compared with private ownership throughout the whole field of industry. In short the discussion of the place of government in economic enterprise leads logically to a consideration of the question of state socialism versus private property. But, of course, one who advocates the regulation of public utilities by the government is not thereby committed to a program of extreme state socialism. While one question leads logically to the other, the difference in degree between government regulation of public utilities and government ownership of all enterprises is so great that the acceptance of one does not involve the acceptance of the other. This is apparent from the fact that perhaps none to-day opposes the government regulation of the railways, for example, while but relatively few favor their ownership by the government, and only an occasional person believes that it would be advisable to institute an extreme form of state socialism.

The Attitude toward Government Ownership. — The logical connection between any extension of government regulation and state socialism is sufficiently close to cause many persons to oppose new forms of regulation, and especially to oppose government ownership in public utilities. This opposition on the part of certain persons may be expressed in terms of a fear complex of socialism. They are so fearful that government ownership may be carried "too far" — that private property rights may be "unduly abridged" — that they oppose any extension of government ownership. Professor Taussig says on this point:

"The business and well-to-do classes of all countries, and especially of English-speaking countries, rarely consider this subject with an open mind. They listen readily to all the evidence that tells against public ownership and are pessimistic about its prospects. The persons now in control of the money-making monopolies supply them freely with all sorts of distorted information and superficial arguments. In the United States more than anywhere else their prejudices are rank. This attitude is due to various causes. In part, it is an inheritance from the older political philosophy of *laissez-faire* and non-interference. In part, it is due to sad experience of misgovernment in this country. But to no small degree it arises from a lurking fear of dispossession. Public management is 'socialistic'; it is feared as the entering edge to complete expropriation."[1]

The question of state socialism and of the ownership and operation of all industry by the government will be discussed in a later chapter. The present discussion will be confined to a consideration of the government ownership of public utilities.

The Extent of Government Ownership. — There is but relatively little government ownership in the United States. As already noted, the post office is owned and operated by the government, and also schools, libraries, roadways and parks are almost exclusively owned and operated by the various branches of the government. These are, however, usually thought of as non-business enterprises. In the field of the so-called public utilities there is some government ownership, but for the most part private ownership with government regulation

[1] *Principles of Economics*, 3d ed., 1921, Vol. II, p. 434.

is the rule. The utility that is most commonly owned by the government is the water system of cities. Some cities own the plants which manufacture and supply artificial gas and there are some cases of city ownership of electric power plants and of railway lines, but for the most part private ownership is the rule with us.

In European countries government enterprise has been carried much further as the following quotation indicates:

> "Monopolies on tobacco, gunpowder, matches, salt and camphor; ownership and exploitation of coal mines, oil lands, water works, heat, light and gas works, railways, telephone and telegraphs; operation of stone works and china and porcelain factories, public nurseries, baths, hotels, theatres, banks; printing and publishing, all forms of insurance, grain elevators, slaughtering houses, drug stores, lotteries, restaurants, and cold storage warehouses may be mentioned as some of the businesses in which national, state and local governments engaged. This list could be swelled almost indefinitely." [1]

This quotation is also applicable in some extent to Australia and New Zealand. The United States, among the modern industrial nations, is the classical land of private enterprise. But changes are under way here, especially in the form of government regulation.

The Advisability of Government Enterprise. — The question as to the advisability of government ownership as compared with private owners turns largely on two questions. First, that of efficiency in the production of the goods or service concerned, and second, that of the prices of the goods and service to the public. The two questions are closely related, but they may profitably be considered separately.

(1) *Efficiency in Government Enterprise.* — The question of efficiency in any enterprise turns on considerations of the ability and interest of the persons employed and on the freedom of the officers to conduct experiments and effect improvements. As between government and private ownership the point is often made that persons in the employ of the government are less efficient than are the persons who are employed in private in-

[1] National Industrial Conference Board, *Tax Burdens and Exemptions*, 1923, p. 5.

dustry. The best men, we are told, do not go into government service, but into private enterprise. Further, it is argued that political considerations determine appointments to the many positions and thus that even if the most able men were inclined to enter public work, they would not necessarily be selected in competition with persons who were less able but who were more useful to the politicians in control. This may be true of government work in certain times and places and not be true in others. That is, under certain conditions the most efficient persons in a community may be in government service and under other conditions this may not be the case. There is nothing in the nature of government industry *per se* that will lead to the persons therein being less efficient or more efficient than are the persons in private industry. Whether the most able persons will tend to enter government service or private industry will depend largely on the general social ideals that prevail.

Individual men act very largely as their fellow men expect them to act; they respond to stimuli as they have been conditioned to respond. If military service on the part of young men is extolled, as it normally is during a war, the young men enlist; if athletic prowess is honored, as it is to-day in American universities, students give their attention to this form of activity; if business success is given public approval, as is the case to-day, especially in America, men strive to make money. There are apparently some exceptions to the general rule in respect to these three forms of activity. Responses are not uniform. Some men do not go to war; some students are not greatly interested in athletics; and some men do not pursue their economic interests whole-heartedly. These exceptional cases often indicate merely a difference in conditioning. Some persons, for example the Quakers, are taught that physical combat is never justifiable and so do not respond to the general social appeal which is made during a war. They respond to a small social group rather than to the larger one. A similar point may be made in regard to the conduct of some students so far as athletics is concerned, and to the conduct of some men as regards money-making.

Men are primarily social. Some unusual persons seem to be

but little affected by the standards that prevail but, broadly speaking, the prevailing standards determine individual conduct. This point was emphasized, it will be recalled, in an early chapter that deals with the institutional character of our economic system.[1]

The application of this to the point at issue is that the degree of efficiency that prevails in business, whether owned and operated by private individuals or by the government, will depend largely upon the ideals that prevail. If service to the government is approved, capable men will enter the political service who would otherwise not do so. Thus, political service has long been more highly approved in England than in the United States and as a result far more young men of ability have entered on public careers there than have done so here. Further, if men are expected to be honest and efficient in individual enterprise but are expected, by certain groups at least, to follow other standards in government enterprise, we may expect that government work will not be conducted efficiently and honestly. Hence, whether the government service will or will not attract the most able men, or whether such men will or will not be zealous in the government service, will depend largely upon whether able men are expected to do such work and expected to do it well.

In illustration of the preceding argument, reference may be made to the public schools of this country. The schools and universities that are under government control have, it seems, been administered as efficiently as the schools and universities that have been under private control. The men and women who hold positions in the public educational institutions are, apparently, no less efficient and no less zealous in their devotion to duty than are those who are employed in the privately owned institutions. This condition prevails, as argued above, because all the general social ideals demand efficient and zealous service in this line of work.

As indicated above, however, the general tradition here has been that private enterprise rather than government service offers a fitting career for men of talent. As part of the general

[1] Chapter V.

condition, politics have been regarded with disfavor to a considerable degree. The opinion has prevailed that capable men do not go into government work. There have been exceptions to this, particularly in the field of education, but as a general rule service in government agencies has not been extolled with us. There is, however, something of a movement away from this traditional attitude. Public service is to an increasing degree offering attractive careers to capable men. The extensive work of regulating public utilities, for example, has led to the enlistment of the services of a very considerable number of highly capable and efficient men in this form of government activity.

Interestingly enough, many of the men who are now giving excellent service to the government as members of public utility commissions occasionally argue against government ownership on the ground that the most able men in the community would not go into such work. They fail to appreciate that the same considerations which have prompted them to undertake the work that they are doing would be similarly applicable in inducing them to take positions of responsibility in the industries concerned if they were owned and operated by the government.

It must also be kept in mind, in discussing this question, that many private enterprises are reputed to be managed very inefficiently. This was the conclusion, it will be recalled, of the committee of engineers that investigated the wastes in American industry a few years ago.[1] Further, one point that is frequently made to the effect that the work of a government is conducted inefficiently, is to an increasing degree applicable to private industry. That is, the work of government offices tends to be impeded by a mass of rules, which are popularly known as "red tape," but a similar condition tends to prevail in large scale private enterprise. The very fact of largeness in size tends to make the operation of private businesses subject to the same check upon freedom that is often encountered in government work.

It must also not be forgotten in considering this question that political corruption in respect to public utilities may be very pronounced under private ownership, as our history well shows.

[1] Chapter XVI, "Industrial Management."

The railway interests of the country seem to have controlled the United States Senate for several years near the turn of the century, and during this period the public utilities in many cities apparently owned the government and used it to their advantage. And recently there have been charges that private owners of public utilities are exerting undue pressure in attempting to control legislation. No system of political control can be successful if the people do not have high political ideals. But as between government ownership and private ownership with public control there is reason to believe that if political corruption prevails, regulation would be preferable to government ownership. The political jobs would be fewer under the scheme of regulation. On the other hand, since government ownership would increase the responsibility of political leaders and voters, it might in such a case lead to an improvement in the general condition. Further, the substitution of government ownership for private ownership would in some cases reduce the economic interest that certain persons have in the government concerned — they would no longer profit as a result of their ability to have political leaders make favorable decisions in respect to rates and service. Hence, the evil influence of such persons on the politics of a community may be removed as a result of government ownership, and the public utilities in question might thus be operated more efficiently under government ownership than under private ownership.

The freedom to undertake experiments and to devise new methods and perfect new processes is essential to a high degree of efficiency in enterprise. It is often argued that government undertakings tend to be less efficient than private enterprise because there is not so much freedom in the one line of work as in the other. This is perhaps generally true. Individual owners may spend money on experiments, and may scrap equipment that has been superseded by new equipment, when persons in the employ of the government would not feel free to do so. On the basis of this consideration Professor Taussig argues that an industry is not ripe for government ownership until it has passed the stage of experimentation. Despite the fact that there is

some merit in this consideration, here as in the aspects of the question already discussed, much depends upon the tradition of the community as to what is advisable. It is conceivable that public officials might be as free in this particular as are the officers of a large private corporation.

Although the preceding analysis suggests the possibility of a high degree of efficiency in government industry, if the general public demands it, it implies that if government ownership should be considerably extended to-day the industries involved would perhaps not be conducted efficiently. The standards for public service are not high and political favoritism is still widespread. Especially, if a large number of employees were involved, the jobs and wages in some communities might be traded for votes. But this very condition being known to the people, means that government ownership will not be extended appreciably, if at all, in the near future, if regulation is proving to be reasonably successful. Believing that government enterprises would not be conducted efficiently, the people will normally refuse to sanction this form of ownership and control.

Another application of this point is that if government ownership is extended this will be done gradually. If it comes to be felt that this is desirable in, say, the giant power industry, this will be undertaken. But this will not be done unless a majority of the people come to favor it, or are believed by the legislators to favor it or to be acquiescent concerning it. And, it may be remarked, government ownership should not be undertaken unless the sentiment for it is so marked that it is clear that the community is definitely committed to government ownership. This would mean, first, that a high degree of efficiency would be demanded of the officials in charge of the work, and, second, that the administrators in charge could make plans and expect to carry them through. This second condition is very important. If administrators are subject to the fear that the project may be abandoned soon, they cannot be expected to do as well with it as they would otherwise do.

(2) *Prices to Consumers.* — The prices, or rates, that are charged by public utilities have a marked bearing on the ques-

tion of the advisability of government or private ownership. Rates tend to vary with the degree of efficiency that prevails. If private ownership and operation are more efficient than government ownership and control, rates will tend to be lower under this plan. This, however, is not the invariable rule. A high degree of efficiency may result in great profit to the owners rather than in low rates to the public. While marked efficiency would mean that the social cost of producing the service in question was low, public sentiment might be intolerant of the receipt of large profits by private owners and insist upon government ownership in order to correct the situation, if it could not be done by regulation.

Regulation of public utilities tends to reduce rates to cost, but as suggested above, the rules applied by commissions and by the courts are not uniform. Frequently rates are approved that seem to many persons to be very unjust to the public. Recently, for example, there has been considerable protest against certain decisions of the United States Supreme Court in which reproduction cost was taken as a basis for rate determination rather than original cost. This meant, it was argued, that the people were called upon to make payments on sums that had not been contributed by the owners. It is contended by many persons that such decisions further the cause of government ownership. This conclusion is undoubtedly sound. If regulatory commissions and the courts do not fix rates that appeal to the public as just, the demand for government ownership and operation will inevitably increase. Also, as noted above, undue influence in politics on the part of public utility interests will tend to further the cause of government ownership.

Public and Private Industries Compared. — Comparisons are frequently made between publicly owned and privately owned enterprises with a view to determining the relative efficiency of the two methods. These comparisons are often made in a very partisan manner. The one making the comparison is usually anxious to prove that one or the other method of ownership is preferable, rather than to determine the issue in a coldly scientific manner. Thus the data that are presented are usually carefully

selected in view of the conclusion desired. But even if one is not actuated by a partisan bias, it is difficult to get much light on the question at issue by a comparison of data of public and private undertakings. All other things are so seldom equal that the conclusions usually have but little validity. The size and location of plants, the methods of keeping accounts, the attitude of the public, and the efficiency of the administrators who happen to be in charge are all variable factors.

The Trend in Respect to Government Ownership. — There appears to be but little likelihood that government ownership will be greatly extended in America in the near future. Regulation, when it is effective, tends to give all of the advantages that could be secured by government ownership and usually if regulation is not effective, government ownership would not prove to be successful. Generally speaking, regulation by the various commissions appears to be carried on very effectively to-day. This condition, as noted earlier, makes it less likely that government ownership will be extended than would otherwise be the case.

There is, however, likelihood that government ownership may be undertaken to some degree in the fields of giant power. This is especially probable in those cases in which government owned water power sites are to be used for the generation of electricity. It is being argued that the state governments, or in certain cases, the national government, should not give public power sites over to private companies. This is being urged in the case of the Muscle Shoals development on the Tennessee River and the Bowlder Dam project on the Colorado River that are under the control of Congress. The private power interests are fighting desperately to have these sites turned over to them. They are maintaining powerful lobbies in Washington and have engaged very capable men to conduct "educational" campaigns against public ownership. The zeal of the private owners suggests that government ownership would be advantageous to the general public. Government ownership might prove that electric power could be developed so cheaply that rates of privately owned plants would have to be scaled down to prevent an extension of

government ownership. The work of generating electric power seems to be well suited to government operation, as compared with most kinds of business endeavors. The problems involved are technical in character, rather than problems in personnel administration. Trained men could easily be secured to conduct such work. Another phrasing for this is that the number of employees would be few, and thus the most troublesome problems from the point of view of political control would not arise.

The railroads of the country were operated by the national government during the World War for a period of a little more than two years. There are differences of opinion in regard to the lessons to be learned from this experience. But when the roads were given back to the owners they were subjected to more government control than had been exercised previously. The problems involved in the government ownership and operation of the railways are far more difficult than those involved in the generation of electricity, for example. The burden of proof is clearly upon one who would substitute government ownership for private ownership subject to government regulation. The issue will no doubt turn upon the success of regulation. If good service prevails at low rates, the present method will doubtlessly be continued, but if not, public ownership will be strongly advocated and perhaps adopted.

Professor Taussig, from whom we quoted earlier, says in regard to the railroads:

"Should it (regulation) not prove successful, the next step must be public ownership once for all. My own judgment is that ultimately this step will be taken and should be taken. The march toward public management may indeed be slow. A half-way plan like that established in 1920 may endure for a considerable period. But the radical change will come in the end. Just as supervision and control by commissions began modestly, first with mere supervision and publicity, then with growing control, finally with regulation of minute details as well as of the general rate of return on capital; so the plan of delegated management, of a sort of partnership, will be followed by complete assumption of ownership and management. Democracy sooner or later must undertake this great adventure." [1]

[1] *Ibid.*, p. 440.

The following quotation from the decision of the United States Supreme Court in a case involving the constitutional power of the state of North Dakota to undertake the ownership and operation of grain elevators, flour mills, banks, and insurance companies, is interesting in this connection. The case involved especially the right of the state to collect taxes and use them in support of these industries:

"The other jurisdictional element presents the question whether the bill shows a case arising under the Fourteenth Amendment. That depends on whether the purpose for which the laws here assailed seek to use the taxing power is private or public. When a state enters a new field of taxation, as North Dakota has in these laws, that question is always raised. It was urged against laws to establish public schools, and publicly owned water, gas, and electric plants, with the same vehemence as it is now urged against present laws. The line of legislative power has been steadily advanced as society has come to believe increasingly that its welfare can best be promoted by public as distinguished from private ownership of certain business enterprises. Laws which at one time were held invalid, have at a later period been sustained by the same court. No judge can investigate judicial decisions rendered during the past ten years without being impressed with the rapid extension of state activity into fields that were formerly private. The twilight zone that separates here permissible from forbidden state action is broad. Business which will seem to one court to be public will seem to another to be private." [1]

PROBLEMS AND EXERCISES

91. In the light of the discussions that you have had with business men in regard to the advisability of government ownership, do you believe that the first quotation from Professor Taussig is sound? Give illustrations to prove your point.

92. How do you account for the fact that there is so little government ownership in the United States as compared with the amount which is found abroad?

93. Does the point in the text relative to the effect of social ideals on the conduct of government employees seem to you to be sound? Give illustrations pro or con.

94. Do you believe that an extension of government ownership would tend to purify or corrupt politics? Discuss.

[1] Scott et al. v. Frazier et al., 258 F d. 669, 1919, quoted in M. G. Gleaser, *Public Utility Economics*, 1927, p. 680.

95. "The Supreme Court boosts government ownership." This statement was used in a discussion of a case in which the Supreme Court overturned the findings of a public utility commission. Under what conditions would there be merit in the contention of the author of the article in question?

96. Does it seem to you that it would be advisable for the national government to enter into the giant power business?

97. Is the point of view expressed in the quotation from the United States Supreme Court in line with the position taken elsewhere in this book?

REFERENCES

Many of the books referred to at the close of the four preceding chapters contain material dealing with this subject. In addition to these, *Public Finance*, by H. L. Lutz, contains statistical material in regard to the present day scope of government ownership. See also the texts and journals listed in the appendix.

CHAPTER XLI

TRADE UNIONISM

Trade Unionism. — In the preceding chapters we have considered several cases of social control in the field of business organization. We come now to a consideration of social control in the field of labor relations. Here, as in the field of business organization, the subject divides itself into two parts: namely, social control by autonomous, group, action and social control by political legislation. Autonomous control in the field of labor relations takes two forms: namely, that of associations of employers in respect to labor relations and associations of employees. It is to the associations of employees that our attention will be especially directed in this chapter.

These associations are most commonly known as trade unions, but various trade unions are differentiated from each other as craft unions, industrial unions, and labor unions. A craft union is made up of workers in a certain craft or kind of work, as plumbers, iron molders, theater stage hands, or railway engineers. An industrial union is composed of persons employed in a given industry, and thus may include persons who perform many diverse kinds of work. By a labor union is usually meant an organization of a group of laborers working at different crafts and in different industries. Such a union is usually very temporary in character and of but little significance. But, to repeat, the term *trade union* is the inclusive one.

The Purpose of the Trade Union. — Trade unions arise as do associations of business men for the purpose of serving the economic interests of the members. The most fundamental purpose to be accomplished is that of restricting competitive bidding among themselves. If the carpenters in a given locality combine into a union and mutually pledge themselves not to bid against each other for employment, that is, if they mutually

agree not to work at less than a certain wage, say $1 per hour, they will be more likely to secure this wage than if each carpenter without regard to the others, bargains with the building contractors or other employers for a job. In short, the immediate purpose of the trade union is to restrict price competition (wage competition) among the members. How well the union can succeed in this will depend on the control that it exercises over the available labor supply of the given type of labor, and on the elasticity of the demand for it. This point will be discussed more fully later. There may still be considerable competition among the members of a union for the available jobs at the price that it set, but there is some disposition on the part of unions to check even this kind of competition.

Trade unions also serve other purposes than the simple one of restricting price competition among the members. They are, to some extent, clubs and appeal to the social and intellectual interests of the wage earners. Several unions also serve as insurance societies for the members. These are, however, minor purposes.

Broadly speaking, a trade union is like an association of business men. The primary purpose in both cases is to serve the economic interests of the members and, further, in both cases the immediate economic purpose to be served is the restriction of price competition among the members. But under the law, business men are prohibited from making agreements not to compete against each other. Associations organized for this purpose are illegal, as has been emphasized in the two preceding chapters. Trade unions, however, are not illegal. Wage earners may form into a combination for the expressed and avowed purpose of raising their wages and yet not be amenable to the law for such conduct. Why is it that the same principles of law do not apply to trade unions as to business organizations? If our government, as the courts so often say, is one of laws and not of men, why are wage earners permitted to do that which is condemned when done by business men?

The Legal Position of Trade Unions. — In answer to the above question, it must first be noted that in the early days of trade

unionism they were condemned as illegal combinations. Not only were the principles of the common law invoked against the organizations of workingmen in England that were being formed during the latter part of the eighteenth century, but parliamentary statutes were enacted to give formal legislative sanction to the common law principles in respect to such combinations of laborers. The anti-combination acts of 1799 and 1800 were the culmination of a long series of acts intended to strengthen and supplement the common law doctrine relative to the illegality of labor organizations. This line of procedure was similar to that which was followed in respect to the organizations of business men in the United States during the late seventies and eighties, as was noted in a preceding chapter. These business combinations were illegal at common law, but statutes were enacted by both the states and the national government to give formal legislative sanction to the common law principles.

This British legislation turned largely upon the idea of conspiracy. While it was legal for one person to refuse to work for an employer at other than a particular wage, the position taken was that if two or more persons mutually agreed to hold out for a given wage such action made them guilty of a conspiracy to injure the employer. The idea was also emphasized that the members of a trade union were guilty of restraint of trade as a result of restricting competition among the members thereof. These laws were enforced only occasionally, but the fact that the compositors of the London *Times* were sentenced to prison for terms ranging from nine months to two years for ordinary trade union activity indicates that the law had teeth when the magistrates desired it to have.

In the United States, too, the early trade unions were under the ban of the law. In a case in Philadelphia (1806) involving boot and shoe workers, the Recorder in his charge to the jury said: "A combination of workmen to raise their wages may be considered in a two-fold point of view; one is to benefit themselves, the other is to injure those who do not join their society. The rule of law condemns both." The jury in this case found the strikers "guilty of a combination to raise their

wages" and they were fined $8 each together with the costs of the suit.[1]

In 1823, in the New York Hatters' case, the judge said, "Journeymen confederating and refusing to work, unless for certain wages, may be indicted for conspiracy. . . . Journeymen may each singly refuse to work unless they receive an advance in wages, but if they refuse by preconcert of association action they may be indicted and convicted of conspiracy."[2]

This legal situation was soon altered both in England and in the United States. In England the combination acts were repealed in 1824 and 1825 largely as a result of the vigorous leadership of Francis Place, "the benevolent tailor of Charing Cross." And in the United States the courts at about the same time began to accept the trade union as legal when it sought to raise wages or shorten hours. In general the rule came to be that trade union activity was legal if the men were seeking to help themselves but illegal if the primary purpose was to injure others, as, for example, non-union members or employers.

To note further the legal position of trade unions as compared with combinations of business men, the Clayton Act, our most recent antitrust law, specifically states that trade unions are not illegal combinations. Undoubtedly, no American court would to-day question the right of a union to exist, although the courts may, and often do, restrict the unions in their attempts to carry out their fundamental policy of controlling the labor market.

The Bargaining Disadvantages of Wage Earners. — To repeat the question propounded earlier, why is it that the trade unions have come to be considered differently before the law from combinations of business men? The fundamental reason for the difference in the two cases is undoubtedly to be found in what may be called the general spirit of democracy. The same notions of justice and of sympathy for the "under dog" that

[1] T. S. Adams and H. L. Sumner, *Labor Problems*, p. 189, quoted by Douglas, et al., *The Worker in Modern Economic Society*, 1923, p. 625.

[2] G. G. Groat, *The Study of Organized Labor in America*, 2d ed., 1926, p. 38.

lead to opposition to monopolies formed by business men, lead to the encouragement of trade unions. The monopolistic combination on the part of business men is normally one that imposes upon competitors and takes advantage of the general public. In the economic struggle such combinations normally have a marked advantage over the other persons in the economic group. In contrast with this, the workingman is usually in a position in which he may be imposed upon by the employer. Indeed, unless the wage earner is a member of a union, the employer may impose wages and conditions of work upon him that do not seem to be equitable to the general public, and at times even the power of the union will not secure "fair" wages.

In short, in the modern industrial system with its dominant large scale enterprise, the wage earner is at a marked disadvantage with the employer in the making of the labor bargain. In the first place, the wage earner is usually without any money reserve. Wages are lamentably low, thus not sufficient to make it possible to save adequately for periods of non-employment. Even in high-wage America only a very low percentage of the wage earners get as much as $1,500 per year.[1] Hence, it is normally necessary that employment be secured at once in order that the worker may take care of himself and his family. The employer may be in need of help in his industrial establishment, but his needs are usually not nearly so urgent as are those of the wage earner. Whether the employer hires an additional half-dozen men on one day or runs his plant without them is perhaps a matter of indifference to him, but to the half-dozen men concerned this may be a very vital matter.

In the second place, entirely apart from the necessitous condition of the employee as compared with the desire of the employer for laborers, the employer is usually a skilled bargainer, while the wage earner is not. That is, the employer is skilled in the technique of making contracts, and if he is particularly successful, this normally means that he is unusually skilled at beating down the price of the person with whom he is bargaining.

There is still another, a third, factor involved in the relation

[1] See Chapter LVI.

between the employer and the wage earner in the making of labor bargains, and that is that employers very frequently have understandings with each other, if not formal agreements, as to the wages that they will pay for given grades of labor. Groups or associations of employers also often agree that one will not hire a person who is already employed by another member of the group. Such understandings and mutual agreements mean, of course, that employers are not competing against each other for their labor supply. This, obviously, places the wage earner at a serious disadvantage in the labor bargain.

These disadvantages of the wage earners, as compared with the employers, have in many cases resulted in very harsh terms of employment. In coal mines, textile districts, and other places where a single industry has been dominant, low wages, long hours, and insanitary conditions of work have been very marked. In such localities, an employer has often further imposed upon the wage earners by making payments to them not in the form of money but in the form of orders (due bills) upon a store owned by the employer. Then, too, in such localities, houses have in many cases been furnished by the employer and the workers were subject to ejection at any time that they made complaints to the employer in regard to the conditions of employment.

In general, then, there have been marked practical differences between the position of the wage earner and that of the employer in the making of the labor contract, and it is out of this difference that has come the disposition on the part of the public generally to accept the trade union as a justifiable combination. This difference between the attitude toward trade unions and that toward business organizations in regard to the right to make combinations and curtail price competition is a striking illustration of the general acceptance of the principle of social control. Practically, the economic society is conceived as an agency for the realization of what is regarded as a good life, and it is adjusted to that end. The economic forces are not regarded as immutable forces that are beyond the control of man. If the application of one principle to groups of business men and another principle to wage earners seems to effect a good adjust-

ment, then these two divergent principles of social control are followed.

Union Organization. — The typical trade union in its organization closely resembles any ordinary association or club. First, we have various local units called locals, or chapters, and these are organized into national or international associations. The term national association is self-evident. An international union in the United States is one that has locals in either Canada or Mexico in addition to the locals in the United States. None of our so-called international unions have locals in the European countries. The various unions have scales of membership dues and fees which differ greatly, varying according to the general wage scales which prevail in the different lines of work. Each union, both in its local chapters and in the national organization, has the usual arrangement of officers and committees that is found in college fraternities and other societies.

The most reliable data in regard to the extent of trade unionism in America are found in a book by Leo Wolman, published in 1924 by the National Bureau of Economic Research. According to Wolman there were 124 national and international unions in the United States in 1923. This was nine less than the number which he gives for 1920. Of these unions, 107 in 1923 were affiliated together in what is known as the American Federation of Labor.

The American Federation of Labor, as the title indicates, is merely a federation of independent unions. The officers of the Federation have no power over the various unions except as the unions may accept the advice and suggestions of the Federation or of the officers of the Federation. In other words, the A. F. of L. has no power to call strikes nor to compel any union to accept any particular scale of wages or working conditions. The A. F. of L. does, however, exercise considerable power because of the vigor of its leadership and also because of the desire of the unions to remain affiliated with the Federation, for, of course, it possesses the power to expel unions from its membership.

A few of the strongest unions in the United States are not affiliated with the A. F. of L.; for example, the four leading

railway brotherhoods; namely, the unions of the locomotive engineers, firemen, railway conductors, and brakemen are not within the Federation. The Amalgamated Clothing Workers is another important union that does not have membership in the A. F. of L.

Craft unionism is by far the dominant type in the United States. There are only two industrial unions of any considerable consequence. These are the United Mine Workers of America and the Amalgamated Clothing Workers. The former of these is affiliated with the A. F. of L., but, as just noted, the latter is not.

In regard to the relationship of the various unions it is interesting to note the conclusion of Professor Hoxie, who at the time of his death was one of the most able students of the labor movement in the United States. Hoxie concluded that there is no such thing as unionism as a single, unitary thing. He said:

"There are in the United States today hundreds of union organizations, each practically independent or sovereign and each with its own and often peculiar aims, policies, demands, methods, attitudes, and internal regulations. Nor is there any visible or tangible bond, however tenuous, that unites these organizations into a single whole. Groups there are indeed with overstructures and declared common aims and methods. But group combats group with the bitterness that can arise only out of the widest diversity of ideals and methods.

"A slight acquaintance with the history of organized labor shows that this situation is not unique, and at the same time furnishes the apparent clues to its explanation. It reveals the fact that unionism has not a single genesis, but that it has made its appearance time after time, independently, wherever in the modern industrial era a group of workers, large or small, has developed a strong internal consciousness of common interests. It shows, moreover, that each union and each union group has undergone a constant process of change or development, functionally and structurally, responding apparently to the group psychology and therefore to the changing conditions, needs, and problems, of its membership. In short, it reveals trade unionism as above all else essentially an opportunistic phenomenon." [1]

The above quotation from Hoxie represents a somewhat extreme point of view. In developing this idea, Hoxie emphasized

[1] *Trade Unionism in the United States*, 1917, p. 33.

the differences among unions rather than their likenesses, but as the quotation implies, Hoxie recognized that there was, after all, a fundamental unity in unionism; that is, that it represents a desire on the part of a group of laborers to band together in order to further their economic interests.

The Extent of Unionism. — The statistics in regard to trade unionism necessarily differ somewhat according to the time of the year or the plan followed in gathering statistics. Wolman, in his study, to which reference has just been made, concludes that in 1923 there were a total of 3,780,000 trade unionists in the United States, of which 2,926,468 were within the A. F. of L. These figures are somewhat less than those for 1920, at which time the corresponding figures were 5,110,800 and 4,078,740. Wolman further classifies these union members into fourteen divisions, with membership for 1923, as follows:

TABLE 2

THE EXTENT OF TRADE UNIONISM IN THE UNITED STATES IN 1923[1]

Mining and Quarrying	415,400
Building Trades	844,400
Metal Machinery and Shipbuilding	358,300
Textile	37,500
Clothing	308,400
Leather	73,100
Transportation	948,300
Paper, Printing and Bookbinding	151,100
Lumber and Woodworking	10,600
Chemical, Clay, Glass and Stone	45,300
Food, Liquor and Tobacco	86,300
Restaurant and Trade	59,100
Theaters and Music	107,600
Public Service	172,200
	3,780,000

It is interesting to note that almost one-fourth of the total trade unionists, according to this table are in the field of transportation, and that almost an equal number are in the building trades. Approximately two-thirds of the total are found in these two divisions and in mining and quarrying.

[1] Wolman, *The Growth of American Trade Unions*, 1924, pp. 120–123.

A very significant question in regard to the number of trade unionists has to do with the proportion which such number bears to the total number of wage earners eligible to union membership. Data are not available in regard to the total number of wage earners in the above groups. But on the basis of a somewhat different classification Wolman reached the conclusions which are given in the following table:

TABLE 3

PER CENT OF WAGE EARNERS ORGANIZED IN MAJOR DIVISIONS OF INDUSTRY, 1920 AND 1910[1]

	1920	1910
Extraction of Minerals	41.0	27 3
Manufacturing Industries	23.2	11.6
Transportation	37.3	17.1
Building Trades	25.5	16 4
Stationary Engineers	12 4	4.6
Stationary Firemen	19.9	9.6
Trade	1.1	1.0
Professional Service	5 4	4.6
Clerical Occupations	8 3	1.8
Domestic and Personal Service	3.8	2.0
Public Service	7.3	2.5

In regard to trade unionism in general, Wolman estimated that in 1910, 9.4 per cent of the eligible wage earners were in unions and that by 1920 the percentage had risen to 18.7. He concludes:

"Compared with the total numbers of wage earners in this country, trade union strength as measured by its membership was relatively twice as great in 1920 as in 1910. . . . Roughly one-fifth of the wage earners of the country were members of labor organizations; whereas in 1910 something like one-tenth were so organized. In other words in 1920, after 10 years of very substantial growth in numbers, about four-fifths of the general category of wage earners were not members of unions."[2]

In short, trade unionism in the United States is still very weak. In contrast with the extent of unionism here, it is interesting

[1] Wolman, *op. cit.*, p. 86. [2] P. 85.

to note that in England where the total population is about one-third that of ours, the number of trade unionists is over twice the number in this country.

Collective Bargaining. — As indicated above, the primary principle of trade unionism is collective bargaining. This means that a mutual agreement as to the minimum terms that will be accepted in regard to wages, hours, and conditions of work is reached by the union and rigidly adhered to in the bargain with the employer. There must be no price cutting by competitive wage earners. In the creed of unionism there is no greater sin than cutting below the established standards. One who does so is a "scab," a "blackleg," a "snake."

A corollary to the general principle of collective bargaining is that in the case of agreements with the employer the bargaining shall be conducted by a business representative of the union. Such officers are sometimes called "walking delegates." Employers, particularly those who oppose the organization of their employees into unions, often object vigorously to dealing with a union representative. They insist that they wish to deal only with their own employees. The union sympathizers argue that an employer takes this position only when he is opposed to the principle of unionism and because he realizes that the business representative is a more fearless bargainer than is an employee of his firm.

Clearly, the position of the union representative before the employer is far different from that of an employee. He does not look to the employer for preferment. He need not fear that he will lose his job, while any employee who demands more favorable terms of employment is in danger of incurring the ill-will of the employer and thus may be denied opportunities for wage increases or other advancement. The union representative, further, is employed by the union and thus his job becomes one of improving the economic welfare of the members of the union. Hence, he tends to be alert to all opportunities to advance wages or to reduce hours. If he is highly skilled, he comes to understand the market for the labor of his union men and the degree of business success that is being enjoyed by the employers in

the industry concerned. He thus knows when it is good policy to ask for an increase in wages and when it is desirable to refrain from making an increased demand. Occasionally, a union representative is hired away from the union by an employer. But in general, the union representative feels committed to living his life within the circles of unionism and attempts to win success by improving the position of the men within his union.

Trade Agreement. — The culmination of collective bargaining is an agreement between the wage earners and the employer and is commonly called a trade agreement. A trade agreement may be only an oral bargain in regard to wages and hours, or it may narrate in great detail the various points that are involved in the relationship between the wage earners and the employer, including specifications as to the procedure to be followed in case of disputes between the two parties.

The detailed trade agreement is the logical development of trade unionism. It indicates on the side of the employer an acceptance of the union and a willingness, if not desire, jointly to agree with the union as to the personnel policies that are to be followed in his plant. The trade agreement has been fittingly called a "constitution for industry,"[1] meaning that it is a formal statement of the rights and privileges of the wage earners in an industry, and that it also provides the machinery for the adjustment of disputes.

There have been many notable examples of trade agreements in American industry. One of the most significant is found in the men's clothing industry between the Amalgamated Clothing Workers and the employers, among which are the firms of Hart Schaffner & Marx and Kuppenheimer. This agreement specifies in detail the rights of the employees through the union. It provides for shop committees in the various plants to consider disputes as they arise from time to time and in case of disagreement upon any point between the employees and the employer it provides for an impartial chairman whose duty it is to hear the case and make a decision that is to be binding upon the two

[1] W. M. Leiserson, *Constitutional Government in American Industries*, American Economic Review, March, 1922, Vol. XII, supplement, p. 61.

parties. In most districts the position of impartial chairman has been filled by professors of economics. This agreement is renewed from time to time but dates from 1916 when the Hart Schaffner & Marx firm first accepted it at the conclusion of a bitter strike. Since that time the union has been extended into other plants and the agreement applied therein.

The various persons who have studied the procedure under this agreement express great admiration for it. The employers concerned say that it has given them a high degree of order in their plants, whereas conditions were chaotic before the union became firmly established. Additional evidence of the success of this trade agreement is found in the continued strength of the union — the Amalgamated Clothing Workers — despite the fact that the clothing industry has experienced dull times during the past few years.

The point which was made in the discussion of commercial arbitration in the preceding chapter can be repeated here concerning the arbitration of labor disputes under an agreement such as that to which reference has just been made. The experience of these arbitrators has been that at the outset many cases were appealed to them, but that as their work continued the number of cases declined. The making of such decisions tends to build up a code of conduct — to establish *standard practice,* and thus tends to prevent disputes from arising.

The Open Shop and the Closed Shop. — The terms "open shop" and "closed shop" are frequently used in connection with the problem of trade unionism. Each of these terms has differed in meaning from time to time in the past and, indeed, is currently used to indicate more than one condition. The most common use of the term "closed shop" means that in a particular industry or firm only trade unionists may be employed; that is, that the shop is closed to non-unionists. Under such an arrangement the union itself may be either open or closed. That is, under a closed shop it may be possible for a non-unionist to secure employment if this is agreeable with the employer, but such a person would be required to join the union. This would then be an open union in a closed shop. But, if the union in

a closed shop should follow the policy of greatly restricting its membership, it could properly be described as a closed union.

By the term "open shop" is most commonly meant a condition in which union members will not be hired or, if they are hired without the employer's knowing that they are members of the union, he will seek an early opportunity to dismiss them. That is, a so-called "open shop" is usually one that is rather tightly closed against unionists. Such a shop would be designated more accurately if the term "non-union shop" were used. Employers who are opposed to unionism, however, prefer the term "open shop" because it connotes a degree of freedom and openness which is commonly regarded as a desirable state of affairs. Here, as elsewhere, the dominant group likes to use a pleasant term to indicate a condition that promotes its interest, and to use a displeasing term to indicate a condition that is opposed to its interests. This is a favorite method with all groups. Labels are a popular form of argument. What might properly be called an "open shop" would be one that is open to either union or non-union workers.

The term "preferential" is often used in connection with these other terms; for example, if preference is given to union members, but if non-union members are not excluded, this condition could be designated by the term "preferential union shop." This, by the way, is the method followed in the clothing industry under the agreement with Amalgamated Clothing Workers. When an employer desires additional workers the union is asked to furnish them, but if the union cannot do this the employer is then free to hire non-union workers.

The Strike. — The trade agreement, as indicated, is the culmination of a bargain between the wage earners in a union and the employer or employers. It connotes peace between the two parties. But peace does not always prevail between the union and the employer. The employer may refuse to deal with the union or he may have been dealing with a union for some time but refuse to accept the proposals of the union representatives in regard to terms of employment. One of the weapons

which is commonly used by the trade union to force the acceptance of its terms by the employers is what is known as a strike. A strike is a concerted absenteeism from work by the employees. The employees during the strike do not leave the employment of the employer in question. They stop work and hold on to their jobs at the same time, or at least they attempt to hold on to their jobs by insisting that no other persons shall be permitted to take their places.

Interesting questions arise in regard to the legality of a strike. There seems to be no question among the courts that the strike is a perfectly legal method of conducting negotiations for the labor agreement if the purpose of the strike is merely to improve the position of the wage earners, in regard to wages, hours, and working conditions. If, however, the purpose of the strike is to injure non-union members, or to injure the employer, the courts may hold that it is an illegal performance and an injunction may be granted by the court ordering the trade unionists to discontinue the strike. Or, while holding that the purposes of the strike are legal the courts may take the position that the methods used are illegal, and issue an injunction to enjoin the strikers from continuing to use the methods in question. It may be that other methods cannot be substituted and thus the strike will be in effect prohibited.

The matter of picketing is interesting in relation to this phase of the problem. If the usual strike is to be successful, it is necessary that pickets shall be used; that is, it is necessary that members of the union shall be stationed about the plant in question in order to induce other persons not to take the places of the strikers. During the coal strike of 1927 an injunction was issued in Ohio enjoining the use of pickets who could not speak English. Such an injunction might make it impossible to carry on a strike that is declared by the courts to be legal. Further, in regard to picketing, the courts uniformly hold that picketing is illegal if it amounts to intimidation.[1]

What is called a sympathetic strike is usually declared to be in violation of the law. This is a strike by a group of persons

[1] See S. Blum, *Labor Economics*, 1925, pp. 135–140, for citation of cases.

who are not seeking to improve their own position but are wishing to exert pressure in order to improve the position of other persons who are striking for an improvement in their terms. Thus, in the construction of a building, if the carpenters should go on strike, a strike by the masons in order to exert further pressure upon the contractors to accede to the demands of the carpenters would be a sympathetic strike.

Strikes are not solely of union origin. There are innumerable instances of rebellion by workers against the conditions of their employment. But most of the strikes grow out of unionization, or of the conditions that lead to the formation of a union. An entire group can hardly quit an employment at one time without a mutual agreement or understanding to do so. Strikes vary in number from time to time. During a period of rising prices strikes are frequently numerous, as employees seek to force employers to share their profits through an increase in wages. The rising cost of labor in such a period may also be a factor in causing employees to press for an increase in wages. Then, too, during a period of falling prices "desperation" strikes may take place as employees seek to resist cuts in their wages, or to prevent the substitution of an open shop for a union shop. Many employers recognize a trade union during a period of prosperity, when the demand for laborers is great, and later as unemployment develops, seek to institute the open shop. Such policies on the part of employers tend to be bitterly opposed by trade unionists.

The strike is at times a very effective weapon, but it is a somewhat dangerous one. The result may be disastrous for the union, and at best it is likely to cost the employees much in the form of lost wages. The general cost to the community may be marked, as the cessation of work in one industry may interfere greatly with the condition of business in other fields of employment. This is especially true if there is a strike of large proportions in transportation or mining. The wage earners in the state of Pennsylvania are said to have lost over $28,000,000 in wages as a result of strikes during the years 1916–1919. The loss from the British coal strike during 1926 was tremendous. Over a million

men were on strike from May until late in the fall. This was the greatest industrial stoppage in the history of modern industry. Not only did the miners lose heavily in the form of wages, but other laborers lost wages because of the unemployment that resulted in other industries on account of the shortage of coal and also because of the reduction in the demands of miners for goods. All unions like to have the employer feel that a strike is possible if the laborers do not get satisfactory terms, but the older unions are very reluctant to resort to strikes.

The Settlement of Strikes. — Many attempts have been made to force the speedy adjustment of strikes by provisions for compulsory arbitration under government authority. These schemes have almost all failed to work, when the decision of the tribunal has been adverse to the wishes of the laborers. Individual wage earners, of course, can be induced to work only as the terms of employment are agreeable to them. "Involuntary servitude" cannot be exacted. And the members of a trade union, as a group, cannot normally be forced to submit to terms that seem to them to be unreasonable. This point is discussed again in a following chapter. In Canada, a method of prohibiting strikes or lockouts in certain lines of industry pending an investigation by an official body has been successful. This plan has been introduced into Colorado.

The United States Department of Labor and also most of the state departments of labor stand ready to use their good offices in the arbitration of labor disputes whenever requested to do so, by the parties concerned. The conciliation service in the national Department of Labor was created in 1913. From then until the close of the fiscal year 1927 it had handled 8,048 disputes involving directly and indirectly approximately 11,000,000 employees.

"During the past five years, 2,558 cases, involving some 2,800,000 workers, have been referred to the conciliation service, and in from 84 to 87 per cent of the cases settlements have been reached. The average of cases handled per month during the five-year period is 51.

"The service at the end of 1926 has before it for settlement 68 cases

involving the relationship between men and management. These cases are from 17 states." [1]

Boycott. — The boycott is another method that is used by trade unionists to enforce their demands upon employers. What is called a primary boycott amounts to the refusal to purchase the goods of a particular employer with whom the union is in disagreement. A secondary boycott amounts to the refusal to patronize a person or firm which is not a party to the original dispute but which is patronizing the employer concerned. For example, a group of stone workers in Indiana at one time served notice upon a theater company that they would not patronize the theater if the theater troupe continued to stop at a certain hotel with which the stone workers were having a dispute. This was a case of secondary boycott.

In California the state courts have held that boycotts are legal, but in most of the state courts and in the United States Supreme Court they have been held to be illegal — to be in restraint of trade, or conspiracies to injure another. The laws of strikes and of boycotts are thus different. Men may agree to withhold their labor — to strike — and they may seek to induce other workmen to join them, provided they do not resort to intimidation, or otherwise act illegally; but they cannot legally agree to withhold their trade. The distinction is seemingly not based upon a difference. Groat says, on this point:

"Judicial opinions of to-day on the boycott sound so very similar to judicial opinions of two generations ago on the strike that the historical view seems to be the only valid one in explanation of this difference. Organized strikes are not new and the rights and obligations in connection with them have been somewhat adjusted to the rights of man. Organized boycotts are new, and such rights and obligations as logically belong to them have not yet been properly subordinated to the more fundamental rights of man. It does not seem possible that any reasoning can endure for long that views the intent in a strike as of itself virtuous and that of a boycott as of itself vicious." [2]

The Label. — Another method used by trade unionists to increase their power is the label. The idea involved is that

[1] *Handbook of Labor Statistics*, 1924–1926, Bulletin 439, United States Department of Labor, p. 44, and Annual Report of Secretary of Labor, 1927, p. 17. [2] G. G. Groat, *op. cit.*, p. 294.

goods which are produced by union workers shall bear a label and that union members shall be discouraged from purchasing articles other than those bearing the label. In other words, the label is used to extend purchases of union-made goods. Quite obviously, the power of the label to coerce employers varies greatly according to the nature of the product. It is particularly effective in the case of goods such as cigars and men's clothing that are purchased by men and are readily recognized as either bearing or not bearing the union label. Other methods by which trade unions attempt to improve their economic position will be discussed in the following chapter.

PROBLEMS AND EXERCISES

98. Compare the ability of a wage earner to get the maximum wage that competition will permit, with the ability of a dealer in raw material to get the maximum price that competition will permit. In how many respects do they differ?

99. "It is generally considered bad form for an employer to entice an employee away from a fellow employer by offering an increase in wages." Is this true? If it is, how do you account for it? Does it at all explain trade unionism?

100. "If we had perfectly free competition among employers and perfect mobility among employees, labor unions would be of no avail in determining wages, save as they limited the number of wage workers in particular employments." Argue in support of this statement.

101. Do you approve of the favored position that trade unions have had in the courts, as compared with associations of business men?

102. Summarize Hoxie's point. Discuss its validity.

103. How do you explain the fact that trade unions have so little strength in the United States, as compared with England?

104. "A trade agreement is like a constitution." Is this true? Discuss.

105. Is there any reason why employers should prefer to use the term *open shop* rather than the term *non-union shop?*

106. "A strike may be legal but it may be illegal to carry it on." Is this true? Discuss.

107. Give an original illustration of what would be a primary boycott; a secondary boycott.

108. Does Groat's point relative to the legality of boycotts seem to you to be sound? Discuss.

CHAPTER XLII

TRADE UNIONISM (*Continued*)

Restriction of Output. — To continue the discussions of the methods used by trade unions in their attempts to further their economic interests, attention will first be given to what is known as restriction of output. The introduction of machinery has been opposed time out of mind, maximum standards of output have been set, and more laborers than are really necessary have been insisted upon. The fact of such restrictive rules and methods is beyond dispute. Further, there can be no question that the restriction of output, except to conserve physical strength, is in the long run contrary to the social interest. There is not just so much work to be done: improved methods cannot permanently displace labor. Increased economic efficiency cannot point toward starvation and squalor.

As more goods are produced per hour there are more goods to be divided and also more hours of leisure to be enjoyed. This is abundantly proved by contrasting the situation in the United States to-day with that of twenty-five years ago in respect to total output, the general standard of living, and the average hours of work. As noted in Chapter VI, output has greatly increased during the past quarter of a century and hours of work have declined. Further, to judge by the dwelling houses of a typical American city and the number of automobile registrations, the standard of living has risen appreciably. And, also, the proportion of unemployment has presumably not increased. Our satisfaction in regard to the standard of living of the great mass of our population, and the normal volume of unemployment should be greatly restrained, but the point to be made is that industrial "progress" has not made our society less satisfactory in these aspects.

We must not fail, however, to note that the benefits of im-

But it is a

provements in efficiency usually accrue to the laboring population only in the *long run.* Immediately, great suffering may be visited upon the individuals who are thrown out of work because a new machine is introduced, or a new method is used, or a faster pace is set. It is in large part as a protection against the calamity of unemployment that trade unionists oppose changing conditions that would increase output. To be sure, the unemployment is only during the *short run* in the life of a society, but it may be long indeed to the displaced workers who wish to eat three times a day.

Restrictions upon the output per worker have, also, often been imposed because of the practice by employers of speeding up workers and then cutting the rates of pay. Such practice has been so persistently followed by many employers, that laborers, who are organized and are able to offer resistance, insist upon a "go-slow" policy on the ground that nothing is to be gained by working rapidly. In some cases, the resistance to speeding up efforts have undoubtedly been in the interest of health and long time working efficiency.

A discussion of the restrictive methods of trade unionists would be incomplete without reference to the restrictive methods of business men. The fundamental purpose of monopolization is to restrict output and, as everyone knows, business men are not unfavorable to the acquiring of monopolies if the law permits. Further, aside from monopolization, manufacturers usually seek to control their output in view of the market. They do not wish to produce more than can be sold at a "fair" price. This is only a gentle name for the curtailment of output. To this end, as stated in a preceding chapter, trade associations seek to assist their members and have, in this particular, received the commendation of the United States Supreme Court. Then, too, the purchase and suppression of patents is frequently practiced and is condoned by law. It may also be mentioned in this connection that public men and business leaders have frequently advised the farmers of the nation during the past few years to curtail output that they might enjoy larger profits. Wage earners alone do not deserve to be scolded on this point.

But to prove that others practice restriction of output is not to prove that it is defensible in unionists. Some of the restrictive practices of the unions are merely the restrictive practices of monopolists, and are, accordingly, indefensible, but some of them are, as indicated above, in the interest of the health of workers and others are devices to ease the cost to laborers of improved methods in industry. The canons of justice demand that the cost of industrial progress should be borne by society as a whole, and not by the most defenseless groups. Compensation should be provided until the displaced workers have been *inducted* into industry again. Until this be done, resistance to improvements by unionists cannot be wholly condemned.

It should be noted here that trade unions are coming to appreciate more fully than they have in the past that labor as a whole can get more, only as more is produced. Leading officials of the American Federation of Labor have recently offered to coöperate with employers in making industry more efficient and have roundly insisted that an increase in output is to the interest of laborers as well as to the interest of employers. The officers of the Amalgamated Clothing Workers have also taken a very advanced position in regard to the importance to the clothing workers of making the clothing industry efficient, and to this end they have pledged their coöperation.

Restrictions on Membership. — In some of the unions, a deliberate attempt is made to keep down the number of workers in the trade. The method used may be to charge a very high admission fee or limit the number of apprentices. This cannot normally occur unless a given line of work is strongly organized, for if non-union workers are employed, the union cannot by restrictive measures on membership improve its position. Indeed, under such conditions a union normally offers every inducement that it possibly can to secure new members. The general lack of strength in American unions would thus point toward the conclusion that restrictions upon union membership cannot be widespread. Further, even if a trade is highly organized, a policy of exclusion, if the demand of employers is growing, would be hazardous, as the number of non-unionists

might be thus increased and the position of the union weakened. The findings of investigators are in agreement with the conclusion of this analysis. While there have been just complaints on this score in some districts, especially in the building trades, such instances are said to be rare.[1]

Limitations upon the Power of Unions. — Like almost all groups in our society most unions are sharply limited in what they can do for their members. As indicated in the preceding paragraph, each union must always have an eye upon the actual or potential non-unionist in its line of work. The analysis concerning monopoly price in Chapter XXIII is in point here. Indeed, this is identical with that problem for this is a question of what laborers can accomplish as monopolists of the labor service in particular trades. As noted in that chapter, the elasticity of demand is a vital element in this respect. Thus, as a group of laborers — for example, brass workers — force up their wages the rise in the price of brass might so cut off the demand that the brass industry would suffer and laborers would be discharged. Plumbers are perhaps in a strategic position in this particular as the demand for their services tends to be highly inelastic. This profits them but little, however, because of the disposition of non-unionists to enter this line of work as wages rise.

Inelasticity in demand for labor service is also found in specialized forms of work in industries that use expensive equipment. Any one kind of labor service in such an undertaking tends to represent such a small portion of the total expense that what is paid for it is of but little moment. The case is similar to that of those consumers' goods that represent but a small part of the usual family budget.[2] In the railroad business, for example, the outlay for the services of locomotive engineers is a relatively small portion of the total expense. This coupled with the importance of having very competent men in these positions gives the Brotherhood of Locomotive Engineers a very strong bargaining position. But aside from a few such cases, the members of a union are sharply limited in what they can get for themselves. They can if they are skillful get more than they

[1] See Groat, *op. cit.*, pp. 354–358. [2] See Chapter XX.

would normally get if bargaining individually with the employers, but not very much more. The alternative choices of consumers, and the competition of laborers with each other, not to mention the influence of employers, limit all of the unions, and sharply limit all but the few that are in very strategic positions. This would be true, too, if all laborers were members of unions.

The Opposition of the Employers. — Many employers oppose trade unions very vigorously. Indeed, the usual experience in American industries has been that employers refuse to accept the principle of unionism so long as there is any alternative. In other words, the usual employer has refused to deal with his employees through the union representative so long as it has been possible to refrain from doing so. That is, in the usual case, the union has been accepted and recognized by the employer only when he has been forced by a strike to accept it. The opposition of the employers has, further, taken the form of the organization of associations to combat trade unionism, or the use for this purpose of associations that also serve the other common interests of employers.

Many employers give lip service to the principle of unionism. They admit that organization is a prominent characteristic of present day economic life, and say that they believe in unionism so long as the unions are properly conducted. This philosophy of employers was well put by Mr. Dunne in the following colloquy between his two famous characters:

"'But,' said Mr. Hennessey, 'these open-shop min ye menshun say they are f'r unions iv properly conducted.'

"'Sure,' said Mr. Dooley, 'iv properly conducted. An' there we are: an' how would they have thim conducted? No strikes, no rules, no contracts, no scales, hardly iny wages, an' dam few mimbers.'"[1]

The Use of the Injunction. — The use of the injunction by the courts in the case of labor disputes is a very effective weapon against trade unions, and, as this implies, the use of the injunction is particularly resented by unions. An injunction is an

[1] From F. P. Dunne in the *Literary Digest*, LXVII (November 27, 1920), quoted in Douglas, et al., *The Worker in Modern Economic Society*, 1923, p. 611.

order by a court enjoining (forbidding) a certain person or persons from performing certain designated acts that are likely to injure another person. This device of the courts has a very long history. In the early English law, the king had the power to say "I forbid" in answer to a request for protection from some imminent danger. This was intended to prevent the injury by stopping the aggressor rather than by promising him punishment after the damage was done. This power of the king was later delegated to chancellors and finally it was transferred to the Courts of Equity.

In the issuance of injunctions there cannot be definite legal standards. Whether the injunction was to be issued in the early days depended upon the conscience of the king, that is, it depended upon whether he believed that it was advisable in the particular case to issue the order forbidding the conduct in question. Similarly in the matter of a modern court, the issuance of the injunction depends upon whether the judge believes that the order should be issued.

When an injunction is disobeyed, the person doing so is guilty of contempt of court and is liable to fine or imprisonment as ordered by the judge. The Clayton Act limits this slightly as it provides that in certain cases one who is held to be in contempt of court may have the right of trial by jury. This applies, however, only to the question as to whether the order of the court has actually been disobeyed and has no reference to the question as to whether the order should have been issued in the first place or not.

Since the question of the granting of an injunction depends upon the judicial conscience, it follows that the social and political philosophy of the judges will determine their action in this particular. More especially the issuance of an injunction in any one case will depend upon the notion of the judge as to the validity of trade unions in general, and as to the validity of the particular practice which he is asked to enjoin. Judges are for the most part conservative in their thinking. In other words, their sympathies are with the owner-employer group rather than with the wage-earning group. Hence, they are

inclined to give the protective power of the injunction to employers who request its use against striking employees.

The first use of the injunction in a labor case occurred in Massachusetts, in 1888, forbidding a group of strikers from displaying banners in an attempt to prevent other persons from taking their places. Injunctions have since been issued to restrain trade unions from picketing, by other means than carrying banners, from boycotting, from conducting sympathetic strikes, and from advocating the continuance of a strike, to mention only a few cases. One of the most sweeping injunctions that have ever been issued came in 1922 during the strike of the railway shop men. In this injunction, which was very elaborate and extensive, union officials were forbidden among many other things "to do or say anything" to induce any person to abandon employment on the railroads. In short, officials were enjoined from using their influence to promote the continuance of the strike.

The fact that the injunction is a relatively new weapon against labor, dating only from 1888, suggests that it is not essential to law and order. Further, an injunction as used in labor disputes is also of recent development in that an injunction could originally be issued only to prevent "irreparable injury" to property, which meant physical property. The right to buy or sell labor service was regarded as a personal right not a property right. To-day the right to hire laborers, to operate a factory, or to conduct business is regarded as a property right and injunctions may be issued to protect these rights in the case of labor disputes.

Trade unionists are constantly clamoring for the discontinuance of the use of the injunction in labor disputes. It seems clear that if they are to succeed they must alter the opinions of the judges. Any legislation that might be enacted by a state legislature or Congress limiting the use of injunctions would undoubtedly be declared by the United States Supreme Court to be unconstitutional, as in violation of either the Fifth or the Fourteenth Amendment to the United States Constitution. Indeed, only recently a law was passed to this effect in the

state of Arizona and was held by the United States Supreme Court to be unconstitutional. The law resulted, so the Court said, in taking property without due process of law and hence was in violation of the Fourteenth Amendment to the national Constitution.[1] To repeat a point made in an earlier chapter, this indicates again the great power which the judiciary exercises in our country in the determination of the kind of economic system that we may have.

Political Analogy. — An interesting analogy can be drawn between the development of trade unionism and the development of political democracy. Political democracy has a long history in England and America. One of the significant dates in this respect is 1215, when the Barons of England exacted the Great Charter from King John. From that time on, bit by bit, political power was extended downward through the various classes until universal manhood suffrage was granted in England in 1884, and woman suffrage, during the World War. In the United States manhood suffrage did not prevail from the beginning. It was not secured until during the 1820's. A few of the individual states have had woman suffrage for many years, but it was only during the World War that the right to vote was extended to the women throughout the nation.

As this long history of the extension of democracy is reviewed, the conclusion seems to be that such extension of political power was inevitable. As the successive groups became better educated and acquired a greater degree of economic power, it became impossible for the groups who were already possessed of political power to retain exclusive control. Similarly, so far as our industrial groups are concerned, as the wage earners have become better educated and have gained an improved economic position they, too, have demanded an increased degree of control over the determination of their wages, hours, and working conditions.

There has, perhaps, always been something of a feeling of subordination on the part of the wage-earning group as a whole, but economic progress has caused increased numbers to strive

[1] Truax v. Corrigan, 257 U. S. 312.

for a larger share in control over their economic lives. This reach for power on the part of the wage-earning group seems to be as inevitable as the struggle for political privilege on the part of the population generally, and it is perhaps as impossible for the employers as a group to prevent the gradual extension of the power of the trade unions as it was for the king and later the Barons to prevent a gradual extension of the right of political suffrage.

The mistakes, or excesses, in the fields of politics and unionism are also analogous. There has been a great deal of corruption in politics. In America, especially, there has been a great deal of this. Voters have been bribed, city councils have been corrupted, state legislatures have been debauched, and high officials in the national Government have been untrue to their trust. Similarly, there has also been considerable corruption among trade unionists. Union leaders have betrayed their members and violated their agreements with employers, and criminal acts of violence have by no means been unknown. But these instances of corruption on the part of trade unionists do not point to the conclusion that unions must not be tolerated any more than do the instances of political corruption point to the conclusion that democratic government should be given up. There is no feeling among American people that democratic government shall be dispensed with despite its many shortcomings. Just as logically, it seems, the conclusion is inescapable that trade unionism will remain with us despite some of the evils that have attended the exercise of trade union power.

Labor Partnership. — The trade union in our economic system has thus far been largely a defensive weapon. It has been conceived in a spirit of opposition to employers and has had for its principal task the resistance to the practices of employers that have been deemed to be inimical to the interests of wage earners. This would appear to be a temporary phase of unionism. It seems reasonable to believe that ultimately the trade union must come to be something of a partner with the owners-employers in the conduct of the various industrial establishments. This would mean that trade unions would come to

accept joint responsibility with the employer for the efficient conduct of industry. There are several signs of this. The Amalgamated Clothing Workers, as already noted, emphasize their interest in the general efficiency of the industry and seek to promote its welfare.

The following statement from the 1916 agreement of this union with the Hart Schaffner and Marx firm indicates the attitude of both parties in relation to the matter of partnership in industry:

> "On the part of the employer it is the intention and expectation that this compact of peace will result in the establishment and maintenance of a high order of discipline and efficiency by the willing coöperation of union and workers rather than by the old method of surveillance and coercion. . . . On the part of the workers it is the intention and expectation that they pass from the status of wage servants, with no claim on the employer save his economic need, to that of self-respecting parties to an agreement which they have had an equal part with him in making." [1]

The Baltimore and Ohio Railroad a few years ago entered into a working agreement with the trade union in the railway shops which puts upon the union a large share of responsibility for the efficient conduct of the various shops.

Considerable attention has been attracted to a scheme known as the Whitley Councils, which was devised in England during the World War. The plan was developed by a committee under the leadership of J. H. Whitley. It provides for a series of local, district, and national councils in which the employers and the employees in any one industry shall have joint representation. The plan thus contemplates that the employers shall be organized into a national association and also that the employees shall be organized into a national union. It was believed that in this way order and regularity could be maintained throughout an industry. Such an organization tends to make the wages, hours, and working conditions the same in the various plants of an industry that uses the scheme.

While this arrangement thus removes the possibility that com-

[1] Blum, *ibid.*, p. 383, taken from J. R. Commons, *Trade Unionism and Labor Problems*, Ser. 2, pp. 534–535.

petition among employers in one industry may make the terms of employment more favorable to the employees, it also removes the pressure upon the liberal employers to reduce the terms of employment in order to meet the competition of the employers who pay low wages, exact long hours, and provide poor working conditions. The lack of active competition in improving the terms of employment is not necessarily a hardship to the employees under such an arrangement, as their representation permits them to press for improved terms when it seems possible to secure them. The most significant feature of the plan is the general provision for the consideration of the problems of an industry by both the employers and the employees. Discussion of the primary questions, so far as laborers are concerned, of wages and hours, leads inevitably to discussion of prices of the product, output, and efficiency in production. Thus the joint conferences tend to raise the laborers to something of the status of partners. Many industries in England have been organized on this plan.

The Whitley Joint Council scheme, as just noted, is posited on the idea of the organization of employees into a regular trade union that is national in scope. There have been a few signs of similar arrangement in this country, but for the most part the councils of employers and employees here have been local. Some of them have been on the union basis, but most of them have been definitely on a non-union basis.

There has, indeed, been a marked movement in this country during the past decade and a half to set up joint-council plans in various establishments with a view to securing better coöperation from laborers, and at the same time preventing the organization of trade unions. These organizations are commonly known as company unions, shop committees, or as schemes for employee representation. The Colorado Iron and Fuel Company, the Standard Oil Company of New Jersey, the International Harvester Company, Swift and Company, and the Goodyear Rubber Company are some of the nationally known firms in which such company unions have been installed.

The method of representation differs in these various plants.

In some, the organization follows that of the national government, there being a house of representatives, a senate, and a cabinet. The general rule is that the representatives of the employees shall be elected by the employees in the various departments or shops of a plant. The representatives then hold frequent meetings and make recommendations to the management. The representatives, too, through the committees which they appoint, act for the employees in controversies of any kind with the management.

These schemes have had varying degrees of success in the different firms. In many cases they have tended toward the creation of a spirit of good will. The very fact of their establishment tends to indicate that the employer is anxious to forsake the "drive policy," in its crudest form, at least, and to enlist the voluntary coöperation of the employees. Very frequently the employees regard the plan with suspicion, but if the management is tactful and sincere the employees can usually be brought to accept the plan and to regard it as a means of furthering their interests.

If an employee representation plan succeeds, it obviously introduces the idea of partnership in industry. It permits the employee to make recommendations in regard to the terms of employment, and it gives the employer an opportunity to enlist the interest of the employees in the success of the business. Such an arrangement also opens the way for various forms of employee coöperations in matters of insurance, pensions, housing, and recreation. The last named feature is usually one of the first to be undertaken. This all tends to give the employee a stake in the successful conduct of the business which he does not have under the old hire-and-fire policy.

Employee representation of the nature indicated may, as already noted, function under a national trade union organization, as well as under a company union. But the two plans — one based on trade unions and the other on company unions — differ sharply in their broader aspects. The employee representatives in a company union represent only the employees of the one plant or company, while the employee representatives

of a trade union represent also the employees of other firms in the industry in question. The problems in the one case are those of one firm, while in the other they are the problems of the entire industry. The control of employees over wages, hours, and working conditions is more definite and certain when all employers are represented. An improvement in terms cannot then be resisted by one employer on the ground that the terms offered by a competitor will not permit the improvement to be made. Resistance to advances must be based on the general condition of the industry as compared with other industries, and with the similar industry abroad, if the product is sold in a world market.

The company union also, as contrasted with the trade union, does not permit the employees to have expert advice from outside labor leaders in the presentation of claims and in the conduct of negotiations. The employer, of course, always has at his command the service of personnel experts, lawyers, and industrial engineers. Further, employees in a company union are far less able to put pressure on an employer by a threat of a strike than are employees that are organized into a national trade union.

It is also contended by some persons that the company union plan does not offer employees as good an opportunity in the development of mutual insurance as is found in the trade union that represents large numbers of laborers scattered over a large area. Further, it may be argued that the trade union fosters the consideration of questions of labor legislation while the company union does not. The influence of the body of laborers on politics thus tends to be less if employees are grouped in company unions than if they are organized into trade unions. Finally, it is pointed out by the friends of the trade unions that employers are organized into local groups and into national associations. They are not content to consider their several enterprises as separate and distinct from each other; they wish to establish common policies as regards prices of output and wages; they wish to hang together. The trade union offers a similar form of coöperation to laborers.

The above discussion points toward the conclusion that the company unions cannot in the long run be a substitute for the trade unions. In many cases, they serve the interests of the laborers splendidly, and in some cases the trade unions, through faulty leadership, are inimical to the interests of the laborers. But generally speaking, the trade union gives to the wage earner a degree of coöperation with his fellows that makes it possible for him to advance his position in the economic society further than would otherwise be possible. If this is true, we may expect that trade unions will grow at the expense of company unions.[1]

But regardless of the relative merits of company and trade unions, the existence of either is evidence of an improved position on the part of the laborer. Personnel problems are receiving far more attention throughout industry than was the case only a few years ago. The democratic movement is being extended to the "hewers of wood and the drawers of water."

In further illustration of the extension of the idea of partnership in industry, attention may be called to the recent development in unemployment insurance. In 1921, such a plan was provided in the Cleveland garment industry, affecting from 2,500 to 3,000 garment workers affiliated with the International Ladies' Garment Workers' Union. The employers are required to build up a fund, or otherwise give guarantees, to make it possible to pay a portion of the regular wages to persons unemployed for more than twelve weeks a year. A somewhat similar insurance scheme was instituted between the Amalgamated Clothing Workers and the Chicago clothing manufacturers in 1923. More than a million and a half dollars were paid out under this agreement during the year ending April 30, 1925. The balance on hand on May 1, 1925, was $564,315. Insurance against unemployment has also been provided in the

[1] For an extended treatment of this subject see "Shop Committees," by Paul H. Douglas, *Journal of Political Economy*, Feb. 1921. Quoted in E. S. Furniss, *Labor Problems*, 1925, p. 557. See also "Company Unions versus Trade Unions," H. R. Seager, *American Economic Review*, Mar. 1923, 13 :1.

clothing industry in New York City, and in the cloth hat and cap industry in several cities. A few unions in other lines of work have also secured insurance against unemployment from their employers, and several firms, as part of their general personnel policy, guarantee a given number of weeks' employment each year. All such provisions tend to mean that the wage earners are given a degree of security in their jobs that they have not had normally.

The development of profit-sharing schemes is also in line with an extension of the partnership idea. Many profit-sharing plans have been ill advised, and some have been deliberately instituted as a means of keeping wages down and reducing the cost of labor to the employer. Such plans have tended to be short-lived. Genuine profit sharing, in addition to the payment of regular or liberal wages, clearly increases the stake of the employee in the business, and gives him something of the interest of a partner.

Upper Class Attitudes. — It is worthy of comment that the prevailing upper class attitude is one of opposition to an improved position on the part of wage workers. This is true even in democratic America, although it is less true here than in the countries where class lines are more definite than they are with us. An upper class position almost necessarily generates a feeling of superiority toward lower groups, which easily leads to the idea that the class differences are God-given, and that it is sacrilegious on the part of the lower groups to question the validity of the classification. Wages, hours, and conditions of employment that would be intolerable to the upper class person are very easily justified for the lower group. The lower groups are expected to "keep their place," and any transgression is an almost unforgivable sin, even aspirations for an improved standard of living are often regarded as preposterous. Kipling's idea that "The Colonel's Lady and Judy O'Grady are sisters under the skin" is normally foreign to upper class thinking.

To quote further from Kipling, class lines and class ideas are graphically set forth in his poem *The Sons of Martha*, which is

based on the scripture story of the visit of Jesus to the home of Mary and Martha.

. . . .

It is their care in all the ages to take the buffet and cushion the shock.
It is their care that the gear engages; it is their care that the switches lock.
It is their care that the wheels run truly; it is their care to embark and entrain,
Tally, transport, and deliver duly the Sons of Mary by land and main.

They say to mountains, 'Be ye removéd.' They say to the lesser floods 'Be dry.'
Under their rods are the rocks reprovéd — they are not afraid of that which is high.
Then do the hill-tops shake to the summit — then is the bed of the deep laid bare,
That the Sons of Mary may overcome it, pleasantly sleeping and unaware.

They finger death at their gloves' end where they piece and repiece the living wires.
He rears against the gates they tend: they feed him hungry behind their fires.
Early at dawn, ere men see clear, they stumble into his terrible stall,
And hale him forth like a haltered steer, and goad and turn him till evenfall.

. . . .

As in the thronged and the lighted ways, so in the dark and the desert they stand,
Wary and watchful all their days that their brethren's days may be long in the land.

Raise ye the stone or cleave the wood to make a path more fair or flat;
Lo, it is black already with the blood some son of Martha spilled for that!
Not as a ladder from earth to Heaven, not as a witness to any creed,
But simple service simply given to his own kind in their common need.

And the Sons of Mary smile and are blesséd — they know the angels are on their side.
They know in them is the Grace confesséd, and for them are the Mercies multiplied.
They sit at the Feet — they hear the Word — they see how truly the Promise runs;
They have cast their burden upon the Lord, and — the Lord he lays it on Martha's Sons!

Any economic society must utilize the principle of division of labor, and it is inconceivable that the different lines of work should be of equal social importance, or should be rewarded equally in a society of private property. Differences in the social esteem attaching to different lines of work and differences in economic reward are vital aids to the placement of persons according to the social needs. But this purpose can be served only by freedom of opportunity to move from one class to another, and it is in no way defeated by the upward movement of entire groups. Further, in so far as proper placement can be secured with equality in economic reward and in social esteem the more ideal has the society become. The social implications of inequality will be more fully discussed in Chapter LVII.

PROBLEMS AND EXERCISES

109. Give an illustration in which it seems to you that a policy of restriction of output would be justifiable; one in which it would not be justifiable. Give an illustration of a restrictive policy that is not defensive, but that arises because of the desire of laborers to protect themselves.

110. "We must not merely permit the negroes to join our trade unions, we must insist that they do so." — An iron and steel worker. Describe the general condition that you would expect to lead to such a statement of policy. Under what conditions would you expect the white workers to seek to exclude the negroes from their union?

111. Is the quotation from Dooley fair to open-shop employers? Discuss and illustrate from your own experience.

112. Suppose a case in which you would expect an injunction to be granted against strikers; one in which you would expect it to be denied.

113. Mr. H. B. Endicott, senior member of the Endicott-Johnson shoe manufacturing company, said in an article in the New York *Times* of October 5, 1919, relative to labor councils within industrial establishments, "I do not see wherein they are of any good. . . . It seems to me that the manager of the plant is pretty well informed as to what are the proper hours, wages, and conditions of labor. The fact that he has to have a council sit in with him and tell him what they are seems to prove that there is something radically wrong. If he is seriously interested in the happiness and well-being of his men he will do the right thing by them irrespective of a council or not." Substitute a few words to make this a statement that a medieval king might

have made when discussing the advisability of having a parliament. Is this substitution fair to Mr. Endicott?

114. Samuel Gompers, president of the American Federation of Labor, in testifying before the Senate committee that was investigating the steel strike in 1919 referred to the welfare work of the United States Steel Corporation as "hell-fare work." Account for his attitude.

115. What is meant by partnership between employers and employees in industry? Does it involve joint ownership?

116. Suppose a case in which a profit-sharing scheme could not reasonably be expected to succeed; one in which it would.

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G. G. Groat, Introduction to the *Study of Organized Labor in America*, 2d ed., 1926, deals exhaustively with the subject of trade unionism. R. F. Hoxie, *Trade Unionism in the United States*, 1917, is an excellent interpretation of trade unionism. *Industrial Democracy*, 1902, by Sidney and Beatrice Webb, two English scholars, is a classic in this field. For other references see Chapter XLIV.

CHAPTER XLIII

LABOR LEGISLATION: CHILD LABOR AND HOURS AND WAGES

Labor Legislation. — A very important form of control over labor relationships, as suggested by the preceding chapters, is that of legislation by the political governments. Shortly following the beginning of the Industrial Revolution, it became apparent that employers were imposing grievously upon their employees and beginnings were made in legislation looking toward a correction of some of the most flagrant abuses in this respect. Such legislation was extended very slowly in the United States, but within the past three or four decades a large volume of labor legislation has been enacted.

This legislation has encountered strong opposition because of the spirit of individualism which has prevailed in this country. The philosophy of individualism was widely accepted during the latter half of the eighteenth century, in America, England, and France. According to the accepted doctrines, men were free to choose the kind of government that they would have, and to order the other phases of life as well. This philosophy helped to furnish a justification for the political independence of America from England, and not only influenced the structure of our national Constitution and of the state constitutions but became firmly embodied in the thought of the people. The political orations of the revolutionary period, which were repeated throughout the succeeding generations, emphasized the liberty and independence of individuals, and our songs and stories extolled the sanctity of the individual and the blessings of freedom. "Freedom" and "liberty" became the shibboleths of America.

Interestingly enough, at the time when these ideas were thus being formulated into the constitutions of our governments and becoming part of the national creed, economic forces were pro-

ducing a condition of interdependence that made it quite impossible for the individuals in the wage-earning groups to exercise the degree of freedom of choice which had been posited in the conclusions of the political philosophers. But in the attempt to enact legislation to correct some of the evils which were arising out of the increased degree of interdependence, the political presuppositions were effective barriers, and this situation prevails to some extent yet to-day. Throughout our national history one of our most puzzling problems has been how to adapt a system of judicature founded in extreme philosophic individualism to the needs of organic society.[1]

This has been especially difficult because of the position of the judiciary in our political system. As suggested previously, our written constitutions necessarily throw upon the judiciary the power of interpretation. The national Constitution prescribes the power of the national government and at the same time restricts the activities of the various states, but the Constitution is at any one time what five of the nine Supreme Court judges think that it is, or think that it ought to be. The Court's power is especially great in the matter of labor legislation as well as in that affecting the regulation of other forms of economic conduct, because of the Fifth and the Fourteenth Amendments, as was indicated in the discussion of the power of the Court in regard to public utility regulation. The Court may declare unconstitutional and invalid the statutes of Congress under the Fifth Amendment as well as the statutes of any state under the Fourteenth Amendment, when they are deemed by a majority of the judges to take "life, liberty or property without due process of law," that is, in an unreasonable manner.

Very frequently the judges have held to an individualistic interpretation of social and economic conduct that has led them to declare unconstitutional laws of Congress and of the various states that have been passed in order to safeguard the persons in our society who are least able to take care of themselves in the face of the large scale organization of industry.

[1] Cf. A. C. McLaughlin, *The Courts, the Constitution and Parties*, 1912, Chapter V.

Child Labor. — The first law that was enacted regulating the labor of children came in England in 1802. This law prohibited the employment in factories of children who were below the age of nine years, and it limited the labor of children above this age to not more than twelve hours per day. The terms of this legislation indicate a woeful state of affairs and suggest a crying necessity for the legislation which was at that time enacted. Even this legislation was, however, bitterly opposed in England, and it was not until 1833 that all textile mills were brought within the operation of the law. Following this later date, additional legislation has been enacted from time to time in England. In 1920, child labor was prohibited and eight hours per day were prescribed as the maximum working period for young persons.

In the United States, labor legislation began in 1842 in the enactment of laws in Massachusetts and Connecticut which established a maximum working day of ten hours for children under twelve in manufacturing plants and children under fourteen in cotton and woolen mills. Child labor legislation following this date was extended at a remarkably slow pace in view of the apparent need for such legislation. At the present time, however, all of the states, with the exception of Wyoming, have minimum age requirements for working children, and Wyoming has a compulsory school attendance law which limits the employment of children during the time that the schools are in session. The age limit is fourteen for employment in factories and workshops in all of the forty-seven states having such laws with the exception of four states[1] in which the minimum age is fifteen, and three[2] in which it is sixteen. The minimum age prescribed for work in mines is higher in almost every state. A maximum number of hours that children may work per day is prescribed in all of the states except Georgia, and in all of the states maximum hours per week are prescribed. In Georgia and North Carolina, however, the weekly limit is sixty hours. Forty-eight is the maximum number permitted in most of the states.[3]

[1] Maine, Michigan, Rhode Island and Texas.

[2] California, Montana and Ohio.

[3] *Handbook of Labor Statistics*, 1924–1926, Bulletin 439, United States Department of Labor.

Child labor legislation in the various states has not encountered the opposition of the courts. Since minors are legally wards of the state, the principle of freedom of individual contract has not been applied to them. That is, the courts have never held that a law that restricted the bargaining rights of children or of parents for children was unconstitutional as in violation of the general principles of liberty and freedom of contract. National legislation on the problem of child labor has, however, in two significant cases been held to be unconstitutional on the ground that Congress had exceeded the power granted to it by the Constitution.

National child labor legislation has long been advocated by students of the problem because many of the states have very inadequate laws on the subject. Further, the fact of inadequate legislation in any one state has made it difficult to secure legislation in states that would otherwise have accepted it, since the employers that were to be affected by the higher standards have resisted such legislation on the ground that this would place them at a competitive disadvantage with employers in the states where lower standards prevail. Hence, it has seemed that it is only by national legislation that it will be possible adequately to prohibit the employment of children throughout the country. Accordingly, in 1916 Congress passed a law that in effect prohibited the employment of children under sixteen years of age in mines or quarries, and under fourteen years of age in factories, and also prohibited the employment of any child between the ages of fourteen and sixteen years in factories for more than eight hours per day or more than six days per week or during the night.

The United States Constitution gives to Congress the power to regulate interstate commerce. It was on the basis of this grant of power that Congress passed this child labor law. The law provided that goods that had been produced in any factory, mine or quarry within the United States could not be shipped from one state to another if children had been employed in such establishments contrary to the terms just quoted, within thirty days of the time the goods were offered for shipment. This law

was held unconstitutional by the Supreme Court by a vote of five to four. "Over interstate transportation or its incidents," said the Court, "the regulatory power of Congress is ample, but the production of articles, intended for interstate commerce, is a matter of local regulation." [1]

Following this adverse decision of the Supreme Court, Congress in 1919 passed another law embodying the same standards as to ages and hours, but it based this law upon the taxing power of Congress rather than upon its power to regulate interstate commerce as in the previous law. The new law provided that a tax of 10 per cent should be collected upon the net profits of any employer using children in violation of the act. This law was also declared unconstitutional with only one of the nine judges dissenting. The Court took the position that if this law were valid Congress could under the guise of the taxing power exercise unlimited control over the affairs of the various states. That is, that political independence of the states would be destroyed and this would "break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states." [2]

Hours of Women. — Legislation in England restricting the labor of women was enacted during the early part of the past century. They were regarded as wards of the state as were children. In the United States there has been less certainty on this point. The general principle of freedom of contract has been in part applied to them. A significant case in this respect arose in Illinois as a result of a law passed in 1895 which restricted the hours that women might work. This law was declared to be unconstitutional. It was held that to restrict the hours that women might work amounted to a confiscation of their property rights and hence was unconstitutional.[3]

But in 1908 the Supreme Court of the United States was called upon to make a decision in regard to a law passed in Oregon which prohibited the employment of women for more

[1] Hammer v. Dagenhart, 247 U. S. 251.
[2] Bailey v. Drexel, 42 Sup. Ct. 449.
[3] Ritchie v. People, 155 Ill. 98 (1895).

than ten hours per day. It was charged, of course, that the law took away the property right of women to contract freely with employers, and hence, that it was in violation of the Fourteenth Amendment. A significant feature of this case was the compilation of a large mass of facts all of which tended to show that long hours of labor per day were injurious to the physical health of women and hence that the general vitality of the race tended to be impaired as a result of the employment of women for more than ten hours per day. The Court was greatly impressed by this array of testimony, and held that the limitation on hours of work was in the interest of the general welfare and thus constitutional. In short, the Court concluded that while property had been taken — property rights restricted — this had not been done without due process of law, since the judges believed the law to be a reasonable one.[1] Later, the Supreme Court made a similar decision in regard to a law in California which limited the hours of women to eight hours per day.[2] The constitutionality of laws limiting the hours that women may work thus appears to be settled beyond any doubt. Some regulation of women's hours now prevails in all but five states; one-half of the states limit the hours to nine or less and a few to ten.[3]

It is worthy of note that the recent decisions of the Supreme Court were not based on the idea that women are wards of the state and thus that legislation might be enacted concerning them as it may concerning children. Rather, the decisions were based on the principle that the general welfare of the race may be impaired by the excessive work of women, and, therefore, that the laws are not in conflict with the due process clause of the Constitution.

Men's Hours. — There has been but little legislation in the United States limiting the number of hours that men may work. Generally speaking, the courts cling to the theory of freedom of contract and individual liberty so far as men are concerned.

[1] Muller v. Oregon, 208 U. S. 412 (1908).
[2] Miller v. Wilson, 236 U. S. 373 (1914).
[3] S. Blum, *Labor Economics*, p. 58.

It has, however, long been recognized by the courts that a state legislature or Congress could properly limit the number of hours in public employment. This rests on the fact that in such a case, a state or the nation is the employer, and hence the legislative body is regarded by the courts as acting within the usual power of an employer in determining the length of hours.

The courts have also upheld the right of the states and Congress to limit the number of hours that men may work in the field of transportation. The importance to the general welfare of not permitting men to run or to dispatch trains when they are so exhausted as not to be able to exercise due care has led the courts to accept such regulation as reasonable. Laws imposing a limitation upon the hours of men so engaged have been passed in over a majority of the states and also by Congress in respect to interstate transportation.

In the field of what are strictly private employments, the courts have generally held that such restrictions by taking away the property right of men to bargain freely with employers in regard to the length of time that they may work, are an unwarranted interference with individual freedom and hence unconstitutional. But in the celebrated case, Holden v. Hardy,[1] the Supreme Court held that a Utah statute limiting the hours of underground miners to eight per day was constitutional. This means, of course, that the judges felt that it was reasonable to restrict the hours that men might work underground to eight per day. A few years after this decision was made, the Court was called upon to make a decision in regard to a similar law enacted by the legislature of New York which limited the number of hours that men might work in bakeries to ten per day. In this case the Court held that the law was unconstitutional.[2] It did not seem to the Court that it was reasonable thus to limit the hours of bakers. Hence, they concluded that the legislature had taken property without due process of law.

But within the past decade the Court has shown a more liberal attitude toward state legislation that regulates hours of men.

[1] 169 U. S. 366 (1898).

[2] Lochner v. New York, 198 U. S. 45 (190–).

In 1917 it upheld an Oregon law that provided for a ten-hour day in every "mill, factory or manufacturing establishment," with three hours overtime permitted at time and a half. Mississippi also has a general ten-hour law and a number of states regulate hours in specific industries despite Lochner v. New York.[1] The 1917 decision on the Oregon law suggests that these other state laws would be upheld, although, of course, the Court with its present personnel might refuse to be bound by the decision of the 1917 Court.

The lack of legislation in regard to hours of labor in the United States is in sharp contrast to the situation in England and the European countries. The wage earners of these other countries have not been blessed with the legal freedom of liberty and contract which all wage earners have been presumed to have in this country. Hence, laws which limit the number of hours that employers may force them to work as a condition of employment have not been regarded as encroachments upon their liberty and freedom.

It is interesting, indeed, that our courts have construed restrictive legislation in regard to the labor contract as being an encroachment upon the liberty of wage earners rather than as prohibitions upon employers in the interest of wage earners. This attitude on the part of judges grows out of the philosophy of individualism, which, as indicated above, early became part of the social and political thinking of Americans and has continued to be a strong factor, especially in the thinking of our judges, regardless of the fact that large scale industry has largely removed any real freedom of contract from wage earners. If the alternative to working twelve hours per day is starvation — if the employers of a community will not hire men for a shorter period — it becomes rather ludicrous to insist that a limitation upon such periods of employment is in violation of the liberty and freedom of the wage earners.

Wage Legislation. — One of the early conditions faced by wage earners in many sections of this country was the payment by employers in scrip — due bills or orders upon the

[1] Blum, *op. cit.*, p. 61.

company's store — rather than payment in cash. This was regarded not only by wage earners but by disinterested persons as a very unfair method of payment. Laws were accordingly enacted in many states prohibiting the payment of wages in other than cash. In some of the early court decisions upon this point, the learned judges found themselves horrified that such laws should have been passed. They declared that such laws meant that the wage earner was treated as if he were an imbecile and thus not able to make a contract for himself. The blessings of liberty of contract gave to the wage earners, so the courts held, power to make a bargain with an employer to work on any terms or have any manner of payment that might be mutually agreeable to the two parties. Finally, however, the United States Supreme Court took the position that such laws were constitutional, and has so held in several decisions.[1]

But in regard to the amount of wages that may be paid by an employer to an employee, the courts have generally held that this is not a proper subject for legislation. The parties must be left free to bargain in regard to the amount. The other legislation is held to protect the employee's liberty in his bargaining, not to restrict it. The legislation in regard to the amount of wages has almost exclusively concerned the wages of women and is commonly designated as minimum wage legislation.

Minimum Wage Legislation. — What is known as minimum wage legislation has been enacted here and abroad in an effort to raise somewhat the extremely low wages which prevail for certain classes of laborers. The first law of this kind was enacted in New Zealand in 1894, and in 1909, such legislation was enacted in Great Britain. These laws in Australasia and in Great Britain provide for the setting up of boards or commissions for particular industries. These boards are empowered to make an investigation and to prescribe minimum rates of pay in the particular industries. In Great Britain the first act applied to only four industries, but since this time the law has been extended to include a large number of working groups. It is further significant, especially to Americans, that these

[1] See Blum, *op. cit.*, p. 63, for citations.

boards concern themselves with the wages of men as well as women.

The first minimum wage legislation in the United States came in Massachusetts in 1912. Within the next few years, several other states enacted minimum wage laws and Congress passed a similar law to be applied in the District of Columbia. Two of the state laws were repealed so that by 1920 thirteen states and the District of Columbia had provided for the determination of a legal minimum wage. These laws took several forms, but they have applied only to the wages of women. The Massachusetts law was advisory rather than mandatory; that is, a commission was established and its duty was prescribed to be the collection of data in regard to industries where wages were very low; and on the basis of the data thus compiled, the commission was authorized to publish recommendations to the industries involved as to the minimum wages that should be paid. These recommendations were to be published in the papers of the state. Employers were in no way compelled to follow these recommendations, but it was expected that the force of public opinion would be sufficient to induce them to pay the wages recommended by the commission.

In this, the results have justified the faith of the legislators. After a period of fifteen years, the work of the commission is still being carried on. According to the yearly report for 1926, wage increases were recommended for two groups of industries during that year and the cases of non-compliance were very few. One of these recommendations concerned the candy workers for whom a wage of at least $13 per week was recommended. This superseded a former minimum rate of $12.50.

In a few states, the legislature in the enactment of the law prescribed the minimum rates that should be paid. But in the other states, a commission was created, or a commission in existence was empowered, to make investigations and to prescribe minimum rates of pay. This latter method rather than that of definite fixation of minimum rates by the legislature has had the approval of disinterested persons. As was suggested in the chapter dealing with public utility rates, a permanent

commission is much better prepared to conduct such work than is a legislative body.

The question of the constitutionality of the minimum wage legislation that was mandatory was not long in coming to the front. In 1914 the Oregon Supreme Court upheld the Oregon law and in 1916 the case was heard in the United States Supreme Court. Justice Brandeis, who had recently become a member of the Supreme Court, was disqualified during the case because of his having served as counsel during the trial in Oregon. The remaining judges divided four to four. This meant that the Oregon court was not overruled and thus that the law was not declared unconstitutional. This decision was regarded in many quarters as establishing the constitutionality of minimum wage legislation, but in 1923 the law which had been passed by Congress for the District of Columbia came before the Supreme Court. It was charged that this law was in violation of the Fifth Amendment to the national Constitution. By a vote of five to four, the Court upheld this view and declared the law unconstitutional. The right of women to contract freely with their employers in regard to wages was held by the Court to be inviolable. Congress, in setting up machinery which had provided that a woman and an employer could not make a labor contract for less than a designated wage, was declared to have taken property without due process of law. The Court stated that mature women may not "be subjected to restrictions on their liberty of contract which could not lawfully be imposed upon men under similar circumstances." The Court evidently had in mind the recent political enfranchisement of women under the Nineteenth Amendment. This means that the possession of the right to vote by women has made it impossible for women to use their newly acquired political power to secure protective legislation.[1]

This adverse decision of the Supreme Court by implication makes unconstitutional all of the minimum wage legislation in the United States, with the exception of that in Massachusetts, which is optional and not mandatory. Indeed, in 1925 the

[1] Cf. Blum, *op. cit.*, p. 66.

Supreme Court formally held the Arizona law to be unconstitutional. Perhaps the laws in some of the states have become so well established that the employers will not dispute their validity but it would seem only to be necessary to question such laws in the courts in order to have them declared invalid.

Health and Safety Laws. — The first American law regulating safety in factories was passed in Massachusetts in 1877. Such legislation is now part of the laws of most of the states. The federal government has contributed its part to such legislation by imposing requirements upon railroads in regard to the use of devices, such for example as the automatic coupler for cars, as are designed to protect the health and safety of the workers and of the traveling public. One interesting law in this particular applies to the manufacture of poisonous phosphorous matches. For many long years the workers in match factories were subject to a very loathsome disease known as "phossy jaw," because manufacturers chose to use poisonous phosphorus. Congress finally abolished this practice by imposing a special tax upon manufacturers using poisonous phosphorus.

Arbitration Laws. — In 1894, a law was passed in New Zealand which prohibited strikes by employees and lockouts by employers and provided that in all cases of dispute the matter should be referred to an Arbitration Board. For the next ten or twelve years there were no strikes in New Zealand and it came to be known as a land without strikes. The tendency during all of this time was for wages to rise. The decisions of the arbitrators were thus favorable to the demands of laborers for increased wages and hence the laborers were satisfied. But from about 1906, the industrial conditions became less favorable for the payment of high wages and the arbitration courts decided less frequently in favor of the demands of the laborers and this led to strikes.

The compulsory arbitration really means the fixing of wages by the Court. This was clearly the situation in New Zealand. This is acceptable to wage earners only when they are thereby able to secure wages which they believe to be just and proper.

If the decisions are unfavorable to them, it can only be expected that they will make protest and it seems reasonable to believe that these protests will occasionally take the form of the cessation of work.

The compulsory feature of compulsory arbitration brings it in conflict with the principles of individualism and freedom which are such marked features of our present day political institutions. In the state of Kansas in 1920, a law was passed which in effect provided for compulsory arbitration in the case of a certain group of industries. In 1921, this law was declared unconstitutional by the Supreme Court. The Canadian method of compulsory investigation before a strike or lockout may be undertaken has been successful, as stated in a preceding chapter.[1]

PROBLEMS AND EXERCISES

117. Give quotations from the political orators of the revolutionary period to illustrate the point made in the second paragraph of this chapter. Also give quotation from our songs to illustrate the point.

118. Discuss the quotation from McLaughlin in the third paragraph of this chapter.

119. Give an original illustration of a bill affecting labor which if enacted into law in your state would surely be declared unconstitutional by the United States Supreme Court. Why would it be? Explain.

120. Same as the above assuming Congress to enact the law.

121. Distinguish between the two national child labor laws.

122. Account for the difference between the decisions of the United States Supreme Court in the two cases, Holden *versus* Hardy and Lochner *versus* New York.

123. (*a*) Are compulsory minimum wage laws unconstitutional in the United States now? Have they always been? Do you expect that they will be thirty years from now? Explain each answer.

(*b*) What are the general terms of the optional minimum wage law in Massachusetts? Is it unconstitutional? Explain.

[1] Chapter XLI.

CHAPTER XLIV

LABOR LEGISLATION: SOCIAL INSURANCE

The Accident Problem. — Despite the laws that prescribe minimum standards in respect to the health and safety of employees, the toll of industry in accidents and occupational disease is very large. It has been estimated that there are in the United States annually over 25,000 deaths resulting from industrial accidents, about the same number of serious permanent disability cases, and nearly 2,000,000 less serious injuries. This means that on the average four workers are killed every hour of the twenty-four and as many injured every minute. "The toll of life and limb exacted by American industries during the second decade of the twentieth century exceeds the nation's loss in battle from the Declaration of Independence to the present day."

A fatality, on the average, cuts off twenty years of productive labor. The average person who losses an arm or a leg forgoes approximately 50 per cent of his earning power. The exact amount of his loss will depend upon the age, occupation, and previous training of the injured worker, together with the possibilities of his community to offer him suitable employment. The annual economic loss to the United States because of industrial accidents is perhaps not less than $1,000,000,000. //

Accident Compensation. — The attempt to provide regular compensation for all accidental injuries dates from 1884. In that year Germany enacted legislation that made employers liable to their employees for compensation in case of injury and to the dependents of the employees in case of death from an injury. Great Britain passed a somewhat similar law in 1897, and other countries followed in rapid succession. Compensation in these countries amounts to a certain percentage of the weekly wage. In Germany the employers are compelled

to carry insurance to cover their probable losses. English employers are not required to carry insurance, but almost invariably do so in order to protect themselves against loss as a result of accidents to their employees.

In the United States, the first movement toward accident compensation came in 1902 in the enactment of a coöperative insurance act in Maryland. This law was later declared unconstitutional. The federal government in 1900 provided for the continuance of wage payments to injured postal employees and later provided compensation for all injured government employees. In 1910, New York passed the first genuine compensation law. It applied, of course, to private employments, and was compulsory for hazardous occupations, but optional for other lines of work. This law was declared unconstitutional in the following year. During the next year, a constitutional device that will be noted later was hit upon and several states enacted compensation laws. The movement then spread rapidly. To-day (1928) there are only five states without such legislation, namely, Mississippi, Arkansas, Florida, and North and South Carolina.

The practice among the different states is to provide that an injured employee shall be paid a sum equal to a certain portion of his wage, but not more than a specified sum, for a certain number of weeks depending on the nature of the injury. In Ohio, for example, compensation equals two-thirds of the weekly wage, but not more than $18.75 per week, and is paid for 150 weeks in the case of the loss of one hand; 200 weeks if an arm is lost; 100 weeks if an eye is lost; 175 if one leg is lost, etc. In the case of death, most states provide that payments need not exceed 500 weeks, although in a few states payments are made to a widow until her death or marriage.

The sums paid are tragically small conceived as "compensation" for a serious injury, but they are certain and they help to relieve the burden which an injury throws on a wage earner or his family. They represent a great step forward as the following discussion will show.

Employers' Liability. — Before the passage of accident com-

pensation laws, an injured employee's claim for compensation could only take the form of a damage suit against the employer. Cases might, of course, be settled "out of court," but legally the employer was liable only after a successful suit at court by the employee.

The issue in such suits turned on the question as to who was to blame for the accident. If the employee could prove that the employer had not used due care, that he had been negligent, the employee could recover damages, the amount being fixed by the jury that heard the trial. When this law was being developed in England, the cases were relatively simple, as would be to-day a case of accidental injury suffered by a helper in a two-man garage. Either the employee or the employer might have been careless. The jury decided the matter. But as time went on it became more difficult for employees to recover damages in case of injury. The courts came to hold, first, that an employer was not liable if the injury to the employee resulted from the carelessness of another employee. A worker, so the argument ran, knew his fellow employees better than did the employer, and if he continued to work with them, and was injured because of the carelessness of one of them, he could not claim damages from the employer. This rule is known as the fellow servant doctrine.

Second, the courts came to hold that if an injured employee had been at all careless, the employer was not liable even though he had not exercised due care. This rule is called that of contributory negligence. Third, a rule of law was developed that if an injury was caused by a kind of accident that happened frequently, and was a characteristic of the industry, the employee could be assumed to have known of this danger and to have assumed the risk that he might be injured from this cause. Hence, it was held that an employer was not liable in such a case. This is the rule of the assumption of risk.

These three common law defenses which the employer came to have against employees when sued for damages as a result of personal injury were strangely out of place in modern large scale industry. As part of the judicial procedure in a régime

of small scale industry they were equitable. They are still part of our law in the various states, except Louisiana, where the common law has not been used. They apply to personal injury cases involving all persons who are not under the compensation laws, which in most states do not apply to farm laborers and persons hired by employers who have fewer than five employees. Apparently these common law defenses are not regarded as inequitable in the cases that arise concerning the employees to which they now apply. But they were unjust in the accident cases that arose in factories, mines, and railroads. It was only an occasional accident that did not afford the employer an opportunity to escape as a result of one of these three defenses. The financial burden of industrial accident was thus thrown very largely upon the employee. Further, if the wage earner had a good case against the employer — if the employer had not used due care, and if the three defenses were inapplicable — the road to the recovery of damages was a long and expensive one to travel. Attorneys' fees absorbed a large part of the receipts, if any. This was, obviously, a most inadequate way to compensate the wage earners who suffer injury in helping the world to make its living.

Finally, following Germany in 1884 and Great Britain in 1897, New York, as already noted, passed the first genuine accident compensation law in this country in 1910. This law provided that employers in the occupations covered should pay compensation to injured employees, regardless of whose fault it was that the accident took place. As would be expected, this was too much for the courts. They promptly held that to force an employer to pay compensation when he had not been to blame for the accident was taking his property without due process of law, and hence in an unconstitutional manner. Clearly, this law struck a new note in American jurisprudence. It removed the question of personal fault, and made the compensation for accidents one of the costs of running an industry. It substituted social control for the individualism of the past.

This law abrogated rights of employees as well as rights of employers. An injured employee was denied the right to sue

for damages and thus was denied the right to receive as damages a large sum, such as a jury often awarded when the employer was clearly at fault. Instead of the possibility of $25,000 or more in damages, an injured employee was limited to some $2000 as a maximum, depending on the injury. The property rights of both employers and employees were thus clearly invaded by this law. An injured employee could claim only the amount specified as compensation for his kind of injury, regardless of how careless the employer may have been, and the employer was forced to pay regardless of how blameless he may have been. This sudden change could hardly have been tolerated by any American judge.

The legislature of New Jersey then had a very happy thought. It enacted a law which set up machinery for accident compensation, and provided that the employers and the employees might freely choose whether or not they would accept the new scheme. Employees were assumed to accept the law, if they did not specify differently, but employers were required to make application if they wished to come within the law. While the law left the employers perfectly free legally to accept or to reject the new accident compensation scheme, it provided that if an employer did not come within the law he could not use any one of the three common law defenses if sued for damages by an injured employee. This meant that employers were really forced to accept the law, but as they were legally free not to do so, the courts upheld the law, and accident compensation in private industry was established in this country. Other states followed this method. But within a short time, the new method proved to be so superior to the old, that the courts were reconciled even to the mandatory laws. Such laws became "reasonable" to the judges and thus no longer took property without due process of law.

Insurance. — The spirit of the compensation laws is that the burden of accident compensation rests upon employers, as do the other costs of running a business. In most states, the laws provide for insurance in order to make certain the payment of compensation. In some states, however, this is not done and em-

ployees are left to enforce the law by suits in the courts. Employers in such states may choose for themselves as to whether they shall carry insurance. This plan is, obviously, unsatisfactory as it does not assure compensation to injured employees.

There are three plans of making compensation certain by means of insurance. (1) First, the state may require the employer to insure his workmen in some insurance agency. These are usually stock companies, specializing in liability insurance and operated for profit. (2) Second, the state may compel insurance but permit employers to establish mutual companies. That is, businesses of like character may be authorized to form their own insurance companies, which, when organized, operate much as other insurance companies. (3) Finally, the state may go into the insurance business in direct competition with stock and mutual companies, or the state may carry on an insurance business of its own and prohibit private companies from doing any compensation business within the limits of the state. This latter plan is called the exclusive state fund system.

Nevada, North Dakota, Ohio, Oregon, Washington, West Virginia, and Wyoming have exclusive state funds, but Ohio and West Virginia permit self-insurance. California, Colorado, Idaho, Maryland, Michigan, Montana, New York, Pennsylvania, and Utah have state funds likewise, but private companies are permitted to write insurance also. Massachusetts and Texas confine compensation insurance to stock companies entirely. Approximately three-fifths of the compensation insurance is with stock companies, the state funds handling one-half of the remainder. In 1919 the stock companies collected $99,000,000 in premiums; the state funds, $33,000,000, and mutual companies about $27,000,000. Inasmuch as the state funds are not operated for profit, the amount of business done by them is not adequately shown in the total premiums collected. For purposes of comparison, their business in the above year would have been about $44,000,000.

When an employer is insured in a stock or mutual company, or in the state fund, the amount of premiums which he has to pay depends upon (1) the number of persons in his employ, and

(2) the accident hazard of his industry. Some states practice "merit" rating. That is, the rate of premium will depend upon the accident experience of each particular employer. This type of rating is especially significant because of its effect in reducing accidents.

The Scope of Accident Compensation. — As was noted above, not all employees come within our compensation laws. There are variations in this respect among the different states, but usually farm laborers are excluded, and, also, persons engaged by employers who regularly hire less than five (in Ohio less than three) employees. New Jersey is the only one of our states that includes agricultural laborers and also the only one to include domestic servants. Hawaii, a territory, also includes agricultural workers. It has been computed that in 1921, 30 per cent of the total employees in the country were not included. New Jersey covers 99.8 per cent, but only one other state as many as 80 per cent, and fourteen less than 50 per cent.[1] It is usually provided, however, that any of the excluded employers may come within the act by making application to do so, and providing for insurance as required by law. Employers may wish to do this in order to escape liability for damage suits.

Benefits. — The payments made to injured employees are, as stated above, a given percentage of weekly wages, but not more than a prescribed maximum per week. Thus although the percentage of wages may be set at $66\frac{2}{3}$ per cent, a provision that no more than $20 per week shall be paid may reduce the percentage of wages to 40 in most cases. A waiting period is provided in all of the states. That is, an employee is not permitted to claim compensation unless he is disabled for more than a certain period. Originally, two weeks was the usual waiting period, but now one week is the usual length of time that disability must run before compensation may be received.

A Scientific Disability Schedule. — Each year witnesses a long list of amendments to American workmen's compensation laws. Through them many improvements are effected, such as increased benefits, shorter waiting periods, a larger number of

[1] Blum, *op. cit.*, p. 155.

workers insured, and the shortening of the time necessary to settle claims. But despite these additions, the average state compensation law cannot be thought of as being scientifically constructed, especially in regard to the payment of benefits. "Benefits paid by these laws," according to Dr. Carl Hookstadt, former insurance expert with the United States Bureau of Labor Statistics, "are based upon no recognizable principle and in most cases bear little relationship either to the needs of the injured workers and their dependents, or the loss of earning capacity resulting from the injury." The cause of this disparity is to be found in the disability schedules already described. These "flat-rate" schedules, as they are called, do not take into consideration the age or occupation of the injured worker.

Let us suppose that a structural iron worker who receives $60 per week, and a machine operator who receives $30 per week, each sustain the loss of the right foot. Let us assume, further, that in the state in which these men were injured, benefits were limited to a maximum of $15 per week, and that the number of weeks during which benefits would be paid for the injury in question would be 125. Each would receive $15 per week for 125 weeks. The high wage of the structural iron worker does not make his award any higher because of the presence of the $15 limitation. But there is a more important consideration. Because of the nature of the injury the structural iron worker will not likely be able to pursue his trade again, while the machine operator's earning power may not be seriously affected. And if one of these men happens to be thirty years of age and the other sixty, it would seem that their loss would be different because of that fact. California is the only state thus far to appreciate these conditions, and to incorporate into its law a disability schedule designed to measure loss of earning power.

Accident Prevention. — As indicated above, the insurance rates charged to employers if properly adjusted make it to the economic advantage of employers to reduce the hazards of their industries. The state of Ohio has recently gone a step beyond this by providing that in the case of an injury an employer may be assessed as much as 50 per cent beyond the normal

amount of compensation if he has not complied with the safety code.

Aside from this economic pressure, the attention to the accident problem during the past few years has resulted in a marked reduction in accidents especially in some industries. The following data from the iron and steel industry is very interesting in this particular. In a group of iron and steel plants selected by the United States Labor Bureau on the basis of successful work in accident prevention, the frequency rate of accidents per 1,000,000 hours' exposure was reduced from 60.3 in 1913 to 22.9 in 1920 and to 6.8 in 1926. In only one year during this period was the rate more than for the preceding year.

In the iron and steel industry as a whole the rate fell from 69.2 in the period 1907–1911 to 29.9 in the period 1922–1926, and the severity rate fell from 5.0 in this early period to 2.8 in the later one. These reductions are very significant. They indicate a marked lowering of the human cost of producing the iron and steel which are such a vital part of our economic output. But taking the country as a whole, the accident rate does not show an appreciable reduction.

Occupational Diseases. — Closely allied with the problems of industrial accident are those of occupational diseases. They are so called because the causes of the sickness are to be found in the occupation itself. Lead poisoning is probably the most common of these diseases, although its evil effects are rapidly being reduced through preventive legislation. It is encountered in a wide range of industries, especially in paint manufacturing and in printing. Dusts of all kinds affect the respiratory system, many times causing tuberculosis. It is believed that more miners die immaturely because of coal dust than because of industrial accident. Even flour milling brings with it many injurious results. Persons working under compressed air are subject to "caisson" disease. Gases of various kinds are dangerous to health, and noise, likewise, is injurious.

Industrial diseases are probably as serious as accidents but much less attention has been given to them. European countries because of the inclusive nature of their insurance systems, have

made provision for dealing with victims of such diseases. But only five states in this country are in a position to deal adequately with this form of invalidity. California, Connecticut, Massachusetts, North Dakota, and Wisconsin provide compensation for "personal injuries," thereby including occupational diseases within the scope of their workmen's compensation laws. Four other states list a limited number of diseases which are compensable.[1]

Sickness Insurance. — Occupational diseases are responsible for only a portion of the cases of sickness among wage earners. It was reported as early as 1910 that there were some 13,400,000 cases of sickness annually among the persons engaged in gainful occupations in the United States.[2] These cases of sickness represented 284,750,000 days of lost time and $366,000,000 loss in wages annually. While insurance against sickness seems almost as feasible as insurance against accident, American states, with the exception of some attention given to occupational diseases, have done very little to meet this type of emergency. Some of the fraternal organizations provide sick benefits and some trade unions do likewise. A number of industrial concerns and retail stores pay wages or part wages while an employee is ill. Insurance companies provide a wide variety of policies to meet this contingency, but such policies are usually not held by wage earners.

European countries have a different record from that of the United States in dealing with sickness. To satisfy the demands for social reform, the German Government introduced in 1883 a system of sickness insurance. This was the first of a series of such measures enacted under the Bismarck régime. It anticipated the accident insurance law, noted above, in that accidents for the first 13 weeks were considered as sickness and were compensated from the sick fund. The entire country was divided into districts, in which committees of employers, employees and disinterested citizens were organized to supervise

[1] *The American Labor Legislation Review,* Dec., 1925, pp. 316–318.

[2] *Proceedings of the First National Industrial Conference on Industrial Diseases.*

the scheme. The committees in turn were responsible to the Imperial Insurance Office. Each employee had a card to which his employer attached weekly sickness insurance stamps purchased at the post office. Two-thirds of the cost of these stamps was deducted from the employees' wages. The benefits included medical care, hospital service, funeral benefits, and after the third day of illness, a sum equal to one-half of regular wages. Insurance benefits were limited to 26 weeks in any one year. At the beginning of the war over 19,000,000 persons in Germany came under the scope of the act.

In 1911 Great Britain passed the National Insurance Act which provided sickness insurance for some 14,000,000 persons. Employers are required to pay threepence per week for each employee, and also an additional fourpence per week for males and three for females, which amounts may be deducted from wages. In case of illness males are given 10 shillings per week and women 7 shillings per week, but benefits are not paid for more than 26 weeks in any one year.

Sickness insurance, together with the other forms of social insurance to be noted presently, was provided in France in the spring of 1928. This will be noted later in greater detail.

Provisions for Old Age. — Not all persons need assistance in old age. Some never attain it. Others, especially those in the higher income classes, make provision for the future through savings, which in many cases, take the form of insurance policies. But wage earners are likely to face the unproductive period of life with no reserve fund for their support.

To meet the problem of old age, Germany again led the way in 1889 by passing a compulsory old age and invalidity insurance act. Each employer attaches old age and invalidity stamps each week to the card of each employee over sixteen years of age. One-half of the price of the stamps may be deducted from wages. From these premiums, together with an additional amount from the government, it has been possible to pay yearly annuities of something like $50 to those persons who have reached the age of seventy years.

England approached the old age problem in 1908 through

the enactment of a pension measure. Whereas the German worker contributed to the fund from which his annuity was later to be drawn, the English worker received from his government, at the age of seventy, a pension, the funds for the paying of which were procured through taxation. Before receiving a pension the person concerned has to give proof that his income from other sources does not exceed 31 pounds annually and that he is a citizen in good standing. Since the war the pension system of England has been extended, especially in the direction of including more persons under the scope of the act. A large number of widows are receiving larger pensions than before, while the children of these widows are also receiving additional amounts.

In the United States fraternal organizations and a number of trade unions make some provision for those of their members reaching advanced age. Various types of pensions are given by private companies to their employees and in certain of the professions pensions are provided for, although some of these so-called pensions really amount to insurance. Four states, Nevada, Montana, Wisconsin, and Kentucky, have old age pension laws. The first two of these date from 1923. The other two states enacted their legislation in 1925 and 1926 respectively. A similar law was passed in Pennsylvania in 1923, but it was declared unconstitutional. The four laws now in operation are administered by the counties, which are privileged to accept the state law or to refuse to accept it. The minimum age for applicants is seventy in three of these states but in Nevada it is sixty-five. For the most part, the pensions seem to amount merely to what is called outdoor relief, in contrast to indoor relief in poorhouses. This is not in line with the general spirit of old age pensions which is "to make it possible for those reduced to poverty by age to spend their declining years in self-respecting privacy, free from the anxieties of want and the stigma of pauperism."[1] But the friends of the movement insist that it is a step in the right direction.

Unemployment Insurance. — Unemployment, of all of the

[1] Bulletin 439, United States Department of Labor, p. 435.

contingencies confronting the modern wage earner, is the most difficult to relieve through insurance. Most persons will not willingly injure themselves. Nor is it very easy to feign sickness for any considerable period of time. Old age is readily perceived. But to decide if an unemployed person is out of work because he cannot find a job, or because he does not wish to work, is a more difficult task.

In the United States, the average worker is unemployed thirty working days out of each year. This amounts to one-tenth of the normal working time. If this loss were uniformly distributed among all workers there would be less need for insurance. But some workers are unemployed more than others, and most workers have less employment at some times than at other times. Insurance would relieve somewhat the distress which unemployment entails.

Besides providing much needed benefits to the unemployed, unemployment insurance may operate to reduce the volume of unemployment. This may come in part through an augmentation of demand on the part of workers, as compared with what the demand would be if they were unemployed without insurance, as argued in Chapter XXXII, and in part through extra care upon the part of employers. That is, if the premiums that are levied upon employers to provide the funds from which unemployment insurance is paid, are made to vary with the rate of unemployment which the various employers induce as a result of dismissing laborers, this would tend to cause employers to put forth every effort to provide work for their employees.

Some individual plants, as noted in Chapter XLII, have made provision for unemployment payments, and agreements between certain unions and their employers have provided for unemployment insurance. Then, too, many unions have set up unemployment insurance funds for the union members.

(1) *The Ghent System.* —In 1901 the Belgian city of Ghent undertook to subsidize the unemployment insurance system already established by the city's trade unions. Unions and the city treasury jointly paid the premiums, but to union officials was left the administration of the insurance. The smallness of

the area covered enabled a close watch to be kept on employments with the result that any available jobs and unemployed workers were soon brought together.

(2) *Compulsory Unemployment Insurance in Great Britain and Germany.* — The experiment of Ghent was followed a decade later by a much larger one. In 1911 Great Britain, as part of her reorganization program, provided for a system of compulsory insurance against unemployment, thereby taking the lead over Germany, in so far as the inclusiveness of her social insurance system was concerned. The original act applied to only seven industries, which number was increased by subsequent legislation. The foundation of the British scheme is a system of employment exchanges, or agencies. Every unemployed person must be registered at one or more of these exchanges in order to get unemployment benefits. Further, if the labor exchange finds employment for a person he may not continue to draw benefits if he does not take it. But if the wages offered in such a case are not standard wages, or if strike-breaking is involved, the laborer may refuse to accept the work without losing the benefits.

In the insured trades and industries employers are required to attach to the employee's unemployment insurance card five penny stamps weekly, half of which is to be deducted from the employee's wages. At the outbreak of the war some 2,200,000 British workers were covered by this type of insurance, and a reserve fund of £20,000,000 had been accumulated. The great amount of unemployment following the war induced the government to extend the act so as to include a total of 12,000,000 workers. This made the demands on the insurance fund so great that it was necessary for the government to advance huge sums to keep the system in force. This subsidizing policy has been severely criticized and used as an argument against unemployment insurance. It is worth noting, however, that had the government not assisted in this way it would have been called upon to do so in some other manner. As it is, the insurance system, with all of its machinery of operation, although rather badly crippled, is still available for future use.

In October, 1927, as indicated in Chapter XXXII, a very extensive program of unemployment insurance was introduced into Germany. This covers all manual workers and all non-manual workers who have incomes of $1500 per year or less. Agricultural laborers who can support themselves from the land they occupy are the only ones not included. Workmen contribute a share of their wages each week to the unemployment fund, from which benefits will be paid during periods of unemployment. This far-reaching scheme is very significant. The experience under it may be very illuminating.

(3) *Proposed Unemployment Insurance in the United States.* — The United States offers no example of a state unemployment insurance law. A rather unique unemployment insurance scheme has been introduced in the Wisconsin State Legislature on several occasions but has thus far failed to be enacted into a law. It provides for the establishment of mutual insurance companies, in which employers would insure, paying premiums according to the number of employees and the extent of unemployment in their particular concerns. Workers who were temporarily unemployed would receive compensation for not more than one week in four, nor for more than thirteen weeks in any one year. The maximum daily amount to be paid to unemployed men is set at $1.50, and to unemployed women half that sum.

A proposed Massachusetts measure differed somewhat from the above in that it provided for the subsidizing of voluntary insurance through associations in all trades. Premiums would be paid in equal amounts by the insured workers, by industry, and by the state. Workers would be divided into three classes depending upon incomes. Premiums and benefits would correspond to the level of these classes.

Civilian Vocational Rehabilitation. — Workmen's compensation laws changed the condition of the industrial cripple somewhat by making compensation definite and certain. But they could pay only for damage done, and could not restore the worker to self-supporting independence. The same may be said, though perhaps to a lesser degree, of health insurance. Before 1908 it did not occur to anyone that it might be better

to retrain disabled persons for self-supporting work than to maintain them in idleness. In that year a Belgian lawyer succeeded in starting a school for this purpose. But the school lay in the path of the Germans and was forced to disband after the war started. The director of this school went to the French city of Lyons where he established the first "École Joffre." [1] The purpose of this school was to retrain disabled war veterans and at the same time relieve an acute labor shortage. The idea spread and similar schools were established throughout Europe.

In 1917 the United States Government passed the Smith-Hughes law, which included, among other things, provision for the training of persons about to enter, or after entering, employment. One year later the Vocational Rehabilitation Act provided for an extensive system of rehabilitation for soldiers and sailors. In 1920 Congress enacted the Civilian Vocational Rehabilitation Act, which provided for the rehabilitation of civilians whatever the cause of their displacement. The three acts thus form a logical whole. The first may be regarded as purely educational, the second as a temporary measure arising out of the war, but the third is a remarkable innovation in labor legislation which offers possibly the only scientific approach to the problem of adequately dealing with disabled citizens.

It was provided in the terms of the latter act that each state would be responsible for setting up the necessary machinery for a rehabilitation program. Congress provided an annual appropriation of $1,000,000 to be allotted to the states on the basis of population, but only on condition that the sum of federal money spent should be equalled by a like expenditure of state funds. The fact that the federal government is contributing financially gives it a reason for supervising the work of the states, and this it is doing through the Federal Board for Vocational Education. The particular plan of rehabilitation varies from state to state, but the aim in every case is to return the worker to productive capacity. The training which this necessitates may take the form of a course in a technical school, special instruction in a manufacturing or mercantile establish-

[1] Joffre was a popular French Field Marshal during the war.

ment, private tutoring, or training in any other feasible manner. Artificial hands and limbs and all sorts of ingenious devices are provided to enable the injured person to pursue an occupation.

Not all disabled persons have been rehabilitated. In the first five years of rehabilitation practice, however, over 19,000 persons were retrained and returned to employment. It is estimated that the average lifetime value of this training to the recipient is something over $7500. The average cost of rehabilitation per person has been $203. It is interesting to note that the above persons, retrained after being injured, found work in a total of over 600 different occupations, from unskilled jobs to highly technical and professional positions.

Unified Social Insurance. — Professor Cohen of Cambridge University, England, is advocating that every contingency be covered by insurance and that the various forms of insurance be molded into a united system. Certainly, the idea that no person should be left without provision in case of need is a very commendable one, but in addition, it is maintained that a unified system is more efficient and provides insurance at lower cost.

In the spring of 1928, France provided for the most extensive insurance venture that the world has yet seen. All of the forms of social insurance to which reference has been made above are included. The law provides that 10 per cent of all wages and salaries up to 15,000 francs per year shall be paid into a state fund. One half of this is to be taken from the pay of employees and the other one-half is to be contributed by employers. It is assumed that this will amount to about $200,000,000 annually. From this fund, benefits are to be paid to contributors, or to their families, in the case of death, disability, old age, or unemployment, and medical and surgical benefits are to be provided. The provisions of the law are to become effective only gradually. It will not be in full operation until a reserve of $4,000,000,000 has been accumulated. Other European countries, because of the numerous kinds of insurance and the relation which one bears to another, have already realized to some degree the idea of a unified system.

But in the United States the situation is very different. The only type of social insurance which can be said to have made any considerable progress is workmen's compensation insurance. The movement of persons between the states makes it imperative that if provision is to be made to cover various contingencies of life, it must be made in all jurisdictions and in like manner. To accomplish this it will be necessary for the federal government to assume a larger part in the conduct of those affairs now left to the states. Just when this will happen is difficult to predict, but it seems reasonable to expect that it will come eventually, in some form or another.

The Incidence of Social Insurance. — The various forms in which social insurance appears determine to a large degree who it is that bears the cost of the insurance. In workmen's compensation insurance, for instance, it is usually argued that compensation is a part of the cost of production and that the premiums which the employer pays are simply added to the cost of the product, or that if the employer pays benefits directly to his injured employee these benefits make up a part of the production cost. The truth of this customary explanation may under certain conditions be questioned. In so far as insurance affects all industries alike prices will not be raised, and the consumer will not, therefore, pay the insurance. But although the employer is unable to shift the cost of insurance to the consumer of his products he is not without an avenue of escape. Employers as a group, knowing that each worker involves a special charge, will tend to bid less for their services than they would otherwise bid. This may not come immediately but that it will come ultimately appears fairly certain. If an industry is one of monopoly character, the shifting of premium charges will not likely take place. Costs and sales, the former governed by the amount of production, the latter by the price charged, have already been adjusted to secure maximum profits. To change prices, which would be the only way in which the burden of insurance might be shifted, would lead only to a profit to the monopolist somewhat less than before the change was made.

If premiums were assessed upon the hazard of each industry,

there would be, under competitive conditions, an effect upon relative prices. The consumer of the product of the hazardous industry would be obliged to pay something more for the article because of that fact. The above analysis in no wise affects the importance of an adequate system of insurance for injured workmen. If workers as a group pool their interests, the benefits accruing to the unfortunate victim of an accident are marked even if the burden is on the labor group. The opportunities for any one employer to save money by reducing his accident rate are still present.

PROBLEMS AND EXERCISES

124. Why, do you suppose, did the first important compensation act in the United States come so much later than similar acts abroad?

125. When an industrial accident occurred under employers' liability laws the courts decided who was at fault. Under workmen's compensation laws the commissions responsible for the administration of the laws are not concerned very much with fault. How may this change in attitude be explained?

126. Do the three common law defenses seem to you to be just in the case of a "hired man" who is injured while working for a farmer? Cite three supposititious cases to illustrate your point.

127. Suppose a case in which a factory worker would be much worse off because of the existence of an accident compensation law. Does it follow from this that such laws are not beneficial to workmen? Discuss.

128. How may workmen's compensation laws assist in reducing the number of accidents? Explain.

129. How do you account for the fact that only one state in the United States has a disability schedule that may be called "scientific?"

130. If the state retrains an injured workman so that he is able to earn as much after an injury as he did before, is it fair that the employer should pay compensation? Explain.

131. Would you favor a system of unemployment insurance in your state similar to the Ghent system? What are some of the advantages which might result from such insurance? Some of the disadvantages?

132. What is your opinion as to the incidence of the cost of social insurance? Does this cost really come out of wages or out of the other shares in distribution? Develop an argument on this point.

133. What would be some of the obstacles to a scheme of "unified social insurance" in the United States?

REFERENCES

One of the best books dealing with the general subject of labor is S. Blum, *Labor Economics*, 1925. W. B. Catlin, *The Labor Problem*, 1926, also gives a splendid general treatment of the subject. *Labor Problems*, by E. S. Furniss, 1925, is a collection of readings that contains excellent material. J. R. Commons and J. B. Andrews, *Principles of Labor Legislation*, revised, 1920, contains valuable material dealing with practically all phases of the labor movement.

The bulletins of the Bureau of Labor Statistics of the United States Department of Labor contain invaluable material. The *Monthly Review* by this bureau gives excellent current material. See also the economic journals, and the economic textbooks listed in the appendix.

CHAPTER XLV

POPULATION

Diminishing Returns. — The relation of numbers to natural resources is one of the most fundamental problems in economics. The principal aspects of the problem were developed in Chapter VII. The analysis will be further developed here. As indicated in that chapter, all natural resources are subject to the law of diminishing returns.

This means that in the utilization of resources there is one point of relationship at which the output per person will be larger than if there are either fewer or more persons engaged in attempting to use the given resources. This is called the optimum. Since the principle of the optimum prevails in relation to small areas of the earth's surface, it necessarily also applies in respect to the entire surface of the earth. It would be impossible to determine accurately the number that would yield the optimum output for the world as a whole. But within broad limits it could be determined. Anyway, we are safe in saying that a certain number of persons in the world would produce a larger output per person, and thus make possible a higher standard of living, than would be possible if there were either more or fewer persons attempting to use the resources of the world.

The above statement should be qualified by the assumption of a given state of the industrial arts. In other words, as was emphasized in Chapter VII, improvements in industrial processes may make it possible greatly to increase the output from a given area of economic resources, or, of course, from the world taken as a whole. Another way of phrasing this is that under different states of industrial development, the employment of different methods may greatly alter the number of persons that will result in the realization of the optimum in economic well-being. This phase of the matter has been especially significant

during the past several decades. Very important strides have been made in the ability to use more effectively the world's resources. The population of Europe and America has trebled since 1800, but during this time the output in economic goods has apparently more than trebled since economic well-being has increased during this time. But this has not been entirely due to improvements in methods. The utilization of the new resources of the American continents and of Australia has been a very important factor. An interesting question arises in this connection as to whether the increase in well-being would not have been more marked if the population had not increased at this very rapid rate. This will be discussed later.

Malthus. — The statement of the fundamental elements of this problem, as in the paragraphs above, points inescapably to the conclusion that it is necessary that control should be exercised in regard to the number of persons. As stated in Chapter VII, one of the names with which the problem of population is closely related is that of Thomas R. Malthus. His *Essay on Population* was first published in 1798. In the early essay his thesis may be said to have been that the lot of man is inevitably an unhappy one; either numbers will so increase that the population will so press upon resources that only a very meager standard of living is possible, or numbers will be reduced by war or pestilence. Thus there was no alternative from misery. The only choice was as to the form in which we should take our misery. In the subsequent editions of his essay, Malthus took a less pessimistic position. He gave more scope to the limitation of numbers by, what he called, moral restraint, than he had in the earlier edition.

Malthus' position is so often referred to that it is desirable to quote directly from the *Essay*. The following quotation is taken from the sixth edition.

"Through the animal and vegetable kingdoms Nature has scattered the seeds of life abroad with the most profuse and liberal hand. If the germs of existence contained in the earth could freely develop themselves, they would fill millions of worlds in the course of a few thousand years. Necessity, that imperious, all-pervading law of nature, restrains them and man alike within prescribed bounds. . . .

"Many extravagant statements have been made of the length of the period within which the population of a country can double. To be perfectly sure we are far within the truth, we will take a slow rate, and say that population, when unchecked, goes on doubling itself every twenty-five years, or increases in a geometrical ratio. The rate according to which the production of the earth may be supposed to increase, it will not be so easy to determine. However, we may be perfectly certain that the ratio of their increase in a limited territory must be of a totally different nature from the ratio of the increase in population. A thousand millions are just as easy doubled every twenty-five years by the power of population as a thousand. But the food will not be obtained with the same facility. Man is confined in room. When acre has been added to acre till all the fertile land is occupied, the yearly increase of food must depend upon the melioration of the land already in possession. This is a fund, which, from the nature of all soils, instead of increasing must be gradually diminishing. But population, could it be supplied with food, would go on with inexhausted vigor; and the increase in one period would furnish a power of increase in the next, and this without any limit. If it be allowed that by the best possible policy the average produce could be doubled in the first twenty-five years, it will be allowing a greater increase than could with reason be expected. In the next twenty-five years it is impossible to suppose that the produce could be quadrupled. It would be contrary to our knowledge of the properties of land.

"Let us suppose that the yearly additions which might be made to the former average produce, instead of decreasing as they certainly would do, were to remain the same; and that the product of the land might be increased every twenty-five years, by a quantity equal to what it at present produces. The most enthusiastic speculator cannot suppose a greater increase than this. Even then the land could not be made to increase faster than in an arithmetical ratio. Taking the whole earth, the human species would increase as the numbers 1, 2, 4, 8, 16, 32, 64, 128, 256, and subsistence as 1, 2, 3, 4, 5, 6, 7, 8, 9. In two centuries the population would be to the means of subsistence as 256 to 9; in three centuries as 4096 to 13, and in two thousand years the difference would be almost incalculable.

"In this supposition no limits whatever are placed to the produce of the earth. It may increase forever and be greater than any assignable quantity; yet still the power of population, being in every period so much greater, the increase of the human species can only be kept down to the level of the means of subsistence by the constant operation of the strong law of necessity, acting as a check upon the greater power.

"But this ultimate check to population, the want of food, is never

the immediate check except in cases of famine. The latter consists in all those customs, and all those diseases, which seem to be generated by a scarcity of the means of subsistence; and all those causes which tend permanently to weaken the human frame. The checks may be classed under two general heads — the preventive and the positive.

"The preventive check, peculiar to man, arises from his reasoning faculties, which enables him to calculate distant consequences. He sees the distress which frequently presses upon those who have large families; he cannot contemplate his present possessions or earnings, and calculate the amount of each share, when they must be divided, perhaps, among seven or eight, without feeling a doubt whether he may be able to support the offspring which will probably be brought into the world. Other considerations occur. Will he lower his rank in life, and be obliged in a great measure to give up his former habits? Does any mode of employment present itself by which he may reasonably hope to maintain a family? Will he not subject himself to greater difficulties and more severe labor than in his present state? Will he be able to give his children adequate educational advantages? Can he face the possibility of exposing his children to poverty or charity, by his inability to provide for them? These considerations prevent a large number of people from pursuing the dictates of nature.

"The positive checks to population are extremely various, and include every cause, whether arising from vice or misery, which in any degree contributes to shorten the natural duration of human life. Under this head may be enumerated all unwholesome occupations, severe labor, exposure to the seasons, extreme poverty, bad nursing of children, great towns, excesses of all kinds, the whole train of common diseases, wars, plagues and famines.

"The theory of population is resolvable into three propositions: (1) Population is necessarily limited by the means of subsistence. (2) Population invariably increases where the means of subsistence increase, unless prevented by some very powerful and obvious checks. (3) These checks which keep population on a level with the means of subsistence are all resolvable into moral restraint, vice, and misery."

With the general position of Malthus no one can cavil. Any given population has biological power to double its numbers again, and again, and again, if pestilence and war, or the lack of food do not keep the numbers down. Population *can* increase at a geometrical ratio. The production of the earth, however, cannot be increased at a geometrical ratio for any appreciable length of time. The output of food, clothing, shelter and other forms of economic goods cannot be doubled and redoubled in-

definitely. Malthus was most liberal in his assumption that the produce of the earth can be increased over an indefinite period of time at a given arithmetical ratio. Improvements and inventions and the taking up of virgin land, as during the past hundred years, may greatly increase productivity, but it is beyond the bounds of possibility that the output of economic goods can be increased at a geometrical ratio over an indefinite period of time, or even at an arithmetical ratio. Hence, the conclusion of Malthus is inescapable; namely, if numbers are not kept below the point that is biologically possible by moral restraint, they will reach the subsistence limit and be checked in that way.

Former Hazards to Life. — Pestilence and war were very effective in keeping numbers in check for thousands of years. The great number of births per thousand did not result in overcrowding the earth's resources because the death rate was so high. It is rather difficult for us to appreciate the dangers to life to which our European ancestors of only a few hundred years ago were subject. Professor Ross has made some quotations which aptly depict the deplorable state of affairs during the not very distant past.[1] The Dean of St. Paul's says concerning the Middle Ages in Europe:

> "The population question slumbered. The miserable chaos into which the old civilization sank after the barbarian invasions, the orgies of massacre and plunder, the almost total oblivion of medical science, and the pestiferous condition of the medieval walled town, which could be smelt miles away, averted any risk of overpopulation. Families were very large, but the majority of the children died. Millions were swept away by the Black Death; millions more by the Crusades. Such books as that of Luchaire, on France in the reign of Philip Augustus, bring vividly before us the horrible condition of society in feudal times, and explain amply the sparsity of the population."[2]

The ravages of the Black Death during the fourteenth century were undoubtedly somewhat typical of similar epidemics during the preceding centuries. Hecker records that:

[1] E. A. Ross, "How Fast Can Man Increase?" *Scientific Monthly*, March, 1927, Vol. XXIV, p. 263.

[2] W. R. Inge, *Outspoken Essays*, 1919, p. 67. Ross, *ibid.*, p. 264.

"Cairo lost daily, when the plague was raging at its greatest violence, from 10 to 14,000; being as many as, in modern times, great plagues have carried off during their whole course. In China, more than thirteen millions are said to have died; and this is in correspondence with the certainly exaggerated accounts from the rest of Asia. India was depopulated. Tartary, the Tartar kingdom of Kaptschak, Mesopotamia, Syria, Armenia, were covered with dead bodies — the Kurds fled in vain to the mountains. In Caramania and Caesarea, none were left alive. On the roads, — in the camps — in the caravansaries, — unburied bodies alone were seen; and a few cities alone remained, in an unaccountable manner, free. In Aleppo, 500 died daily; 22,000 people, and most of the animals were carried off in Gaza, within six weeks. Cyprus lost almost all its inhabitants; and ships without crew were often seen in the Mediterranean, as afterwards in the North Sea, driving about, and spreading the plague wherever they went on shore. It was reported to Pope Clement, at Avignon, that throughout the East, probably with the exception of China, 23,840,000 people had fallen victims to the plague. . . . In Padua, after the cessation of the plague, two-thirds of the inhabitants were wanting; and in Florence it was prohibited to publish the numbers of the dead, and to toll the bells at their funerals, in order that the living might not abandon themselves to despair." [1]

Thorold Rogers gives an account of conditions in England only a few hundred years ago that indicates that the problem of pressure of the population upon food supply was by no means acute, since disease and pestilence did their work so effectively:

"The habits of the people were favorable to pestilence. Every writer during the fifteenth and sixteenth centuries who makes his comment on the customs and practices of English life, adverts to the profuseness of their diet and the extraordinary uncleanliness of their habits and persons. The floor of an ordinary Englishman's house, as Erasmus describes it, was inconceivably filthy, in London filthier than elsewhere, for centuries after these events. The streets and open ditches of the town were polluted and noisome beyond measure. The Englishman disdained all conditions of health." [2]

The Reduction in the Hazards to Life. — The past hundred years have witnessed a remarkable change in living habits. Further, during this time has come the epoch-making discovery of the nature of infectious disease. To-day, most of the dis-

[1] *Epidemics of the Middle Ages*, 1844, pp. 23, 26. Ross, *ibid.*, p. 264.

[2] *Six Centuries of Work and Wages*, 1884, p. 118. Ross, *ibid.*, p. 264.

eases that formerly took a large toll in human life have been almost entirely eliminated, or, through the process of vaccination, are subject to a very high degree of control. Warfare still plays its part in reducing numbers, as is indicated by the estimate that the World War reduced the population by thirty millions, ten millions dying as a result of battle and twenty millions from plague, disease, and famine.[1] And death from accident claims a considerable number of persons each year. But infectious diseases are kept well in hand.

It is primarily because of disease control that the population of the western world has increased at such a tremendous rate during the past hundred years. Along with this there has been, as already indicated, a tremendous increase in the output of economic goods. These two things have gone together. The improvement in economic welfare has made it possible to give attention to problems of science, and hence, to the problem of disease. Further, if the gains in economic output had not been effected, the present number of people could not exist.

There is a strong movement to-day looking toward the prevention of war. If this should be successful, and if the ravages of disease can be further checked, the population question will become more acute than would otherwise be the case. The contest will lie, so far as human well-being is concerned, between the birth rate and improvement in the economic arts. As indicated earlier, no one knows what the future may bring forth in respect to our ability to use the natural resources. The marvelous development of the past hundred years may be duplicated during the next century, but it does not seem probable that this will be the case. Unquestionably, natural resources are being exhausted. The world has much less in the way of coal, iron, oil, forests, and agricultural fertility than it had a hundred years ago. Unless the birth rate is kept at a very low point it is extremely unlikely that the present state of economic welfare can be maintained.

The Birth Rate. — Happily, the birth rate is decreasing, and,

[1] W. F. Wilcox, "Population and the World War; a Preliminary Survey," *Journal of American Statistical Association*, June, 1922, p. 702.

what is more, it has been reduced more than has the death rate. Thus the rate of natural increase in population is less than was true, say, fifty years ago. But, of course, even a slight annual increase will in time mean overcrowding. An increase of 10 persons per year for every 1000 of the population will mean that the population will double within sixty years. The annual rate of natural increase in Germany is now about 8; in Hungary 9; Holland 15; Belgium 7; England and Wales 6.6; and Italy 13. There is practically no increase in the French population except as a result of immigration. The excess of births over deaths in that country for 1923 amounted to only 94,871 according to the official census.[1] The rates of increase in these several countries are considerably less than those which formerly prevailed, but, to repeat, such increases will in time lead to overcrowding.

During the past 127 years — since 1800 — the population of the world has trebled. The population in Europe also trebled, and that in the United States was multiplied by 23. At the present time the excess of births over deaths adds some 50,000 persons to the world's population every day. By the year 2027, at the present rate of increase, the population of the world will amount to five billions. It is now approximately one and three quarter billions.

The population of the United States is estimated by the Census Bureau to have increased by approximately 1,500,000 during the fiscal year ending June 30, 1927. The net immigration during this period according to official figures amounted to approximately 284,000. It is estimated that in addition perhaps 175,000 persons entered the country illegally. According to these data the excess of births over deaths in the United States for the year indicated amounted to more than one million. The total increase was 1.5 per cent of the total population, or at the rate of 15 per 1000 persons. This is approximately the same rate of increase that prevailed from 1910 to 1920, but it is considerably less than the rate of increase from 1890 to 1900, which was

[1] These data are taken from E. M. East, "The World-Wide Problems of Over-Population," *Current History*, July, 1926, Vol. XXIV, p. 523.

20 per cent for the ten-year period. The declining birth rate is indicated by the fact that no more children were born in the United States in 1925 than in 1916, despite the fact that the population was sixteen millions more in the latter year than in the former. The decline in the birth rate, and increased restriction of immigration may soon bring about a stationary population. As suggested above, this would seem to be more desirable than that the population should continue to increase. Certainly the number of persons that can extract a good living from the resources of the United States is definitely limited.

An interesting point may be made to the effect that the tendency toward a stationary population is cumulative. If a population is increasing, the number of women of child-bearing age is large relatively to the number of old persons, but if population is not increasing, or is declining, the number of women of child-bearing age is relatively fewer than otherwise. This means that the rate of natural increase tends to decrease at an accelerated rate as a movement toward a stationary population sets in.[1] Further, in this connection it is significant that the immigrant women who have come to the United States in such large numbers during the past one hundred years have almost all been of child-bearing age. This has augmented the proportion of such persons in our population. The great reduction in the number of immigrants that are permitted to enter the country will thus alter the birth rate per 1000 of the population. Then, too, the birth rate among foreign-born women has been relatively much higher than that which has prevailed among the native-born women.

The Law of Diminishing Returns Considered Historically. — The race that has been going on for the past one hundred years between population increase and improvement in industrial methods has caused many writers to take an interesting position. They observe the general increase in economic welfare and conclude that there is no law of diminishing returns con-

[1] For an elaboration of this point see L. I. Dublin, "The False Propaganda of Birth Control," *Atlantic Monthly*, Feb., 1926, Vol. 137, p. 186.

sidered historically.[1] The implication is that one need have no concern in regard to the future. The conclusion also seems to follow that any possible increase in numbers would not result in a decrease in welfare. But the fact of an increase in average welfare during the past several decades does not throw any light on the question as to whether the increase would not have been more marked if population had not increased so rapidly. These writers can argue only that welfare has increased. They cannot conclude from the data that the optimum has been secured; that the increase in welfare has been as marked as was possible, in view of the improvements in methods, if the population had not increased so rapidly. In short, they cannot conclude from their data that we have not been in the stage of diminishing returns.

There is, indeed, ample reason for believing that we have fallen far below the optimum; that the increase in numbers has forced us much farther into the stage of diminishing returns than we would have gone if numbers had been less. Certainly, one of the most striking facts of our economic life is that the marvelous improvements of the past several decades have not greatly augmented the welfare of the masses. The Aladdin lamps of industry have not eliminated poverty. The bulk of the people of Europe are still near the level of subsistence, and even in the United States the standard of living of large sections of the population is tragically low in view of the tremendous advance in technique. Per capita production is still meager despite the genius of the inventors. The only possible explanation of this seems to be that the ever increasing numbers have kept us far down in the stage of diminishing returns and thus have kept the marginal productivity low. The stork has almost outflown the eagle of the new industrialism.

The invalidity of the position that the increase in economic welfare warrants the conclusion that the law of diminishing returns does not operate historically, may be shown in another way. The birth rate has been declining in Europe and America

[1] See F. L. Patton, *Diminishing Returns in Agriculture*, 1926, especially Chapter VII.

for many years. The population although augmented at an unprecedented rate during the past one hundred years has not increased as much by far as is biologically possible. The data compiled to prove that returns have not diminished historically have all been based on a limited number of persons. Certainly the most optimistic observers of the history of welfare would not argue that welfare could continue to advance if the population should double every twenty-five years.

The impossibility of such a rate of increase over a long period of time beginning with only one couple was noted in Chapter VII, and also in the quotation from Malthus. Such a rate of increase would multiply the population by 8 in one century and by 128 in two centuries. The appalling result of such an increase if long continued is obvious. The square miles of earth surface are limited. There can be no escape from the position of Malthus. Either population must be checked by *moral restraint* or misery will abound.

The Concept of the Optimum. — The concept of the optimum is of marked social importance. If this idea could be appreciated, the discussion of the population question would be greatly clarified. The analysis of the writers referred to in the preceding paragraphs suffers, as indicated, because of failure to think in terms of the optimum rather than in terms of the degree of welfare that has happened to be realized. Further, much of the popular discussions of this subject is not cogent because of the neglect of the idea of an optimum. One prominent feature in almost all of the discussion is the naïve belief in the desirability of bigness which permeates so much of the popular thinking in respect to the various aspects of life. Newspaper comments upon the population statistics for any period reflect a feeling of gratification if numbers have increased more rapidly than during the preceding census period, and a feeling of disappointment if the increase has been less rapid than formerly. There is usually no explanation as to why larger numbers are desirable; it is merely assumed that they are. If such writers had the concept of the optimum in mind their attitude would almost necessarily be different. At least they would be forced

to argue that larger numbers would increase per capital welfare and this might provoke serious thinking in regard to the problem.

Another element in the situation which indicates a failure to appreciate the fact of diminishing returns and the resulting concept of the optimum, is what may be called the religious attitude of many persons. This is that God is good; that He is abundantly able to take care of His children regardless of how many there are, and, hence, that there need be no concern over the possibility of overpopulation. An appreciation of the simple fact that all natural resources are subject to diminishing returns would tend to dispel such an attitude of mind. In theological terms, it may be insisted that the law of diminishing returns is one of God's fundamental laws, and that He intends that His children shall be governed thereby.

Another element in the popular attitude toward the population question is the spirit of optimism. The pessimist is seldom popular, whether he be a Noah preparing for a flood or an economist preaching the danger of overpopulation. Men and women prefer not to look toward the future with foreboding. This suggests that persons who are concerned about the danger of overpopulation should not emphasize the calamity that may result therefrom, but should instead stress the fact that a better standard of living could be secured in the future than is now realized, if numbers could be so adjusted to natural resources that the optimum could be secured.

The general effect of attaining the optimum population is well stated by Wolfe:

> "Once the optimum were attained, the expenses attendant on population growth would be avoided. Additional hous'ng, public utility extensions, and land reclamation would no longer be essential. Increase of land values and rents would be checked. Slower use and decreased waste of natural resources would retard the increase in the cost of raw materials. Distribution of income would undergo some change. Wages would be higher and interest lower. Business would become less speculative. Costs of consumers' goods would tend to fall."[1]

[1] A. B. Wolfe in *Population Problems*, edited by L. J. Dublin, p. 72.

Causes of the Decline in the Birth Rate. — Despite the elements of thought which have just been indicated, choice is being exercised in regard to numbers. The birth rate has steadily fallen in all modern countries, as already indicated. There are many elements that account for this. One of the most significant ones is the almost universal desire to-day for improvement in material welfare. The desire to have an improved economic position has permeated all classes of the population in Europe and America. This is less prominent in the lower economic groups, but it is not absent among such persons. Another phrasing of this runs in terms of democracy. The lines of division between social classes that were formerly largely hereditary have been broken down to an ever increasing degree during the past century. The persons in the lowest economic group may aspire to membership in the higher groups. Such social advancement depends largely upon economic income.

The increasing emphasis on economic welfare means that most persons regard children as an economic burden, and also that they are anxious to give to their children educational opportunities that will make it possible for them to prosper and to have a standard of living that is deemed to be fit. The very large increase in the portion of the population that attends high school and college is striking evidence of this.[1] This means that the cost of rearing children has increased tremendously during the recent decades. The modern city child in the middle and upper economic groups involves a great outlay in money, and often makes no contribution at all to the family exchequer. The contrast between modern urban life and life on the farms fifty years ago is most marked in this respect. Formerly, the population was largely agricultural and only a minimum of school attendance was deemed to be necessary. Under such conditions, children were economic assets to their parents. To-day, less than 30 per cent of the population live on farms, and even with this group there is growing emphasis on the importance of attendance at high school and college. Thus even on the farms children have lost much of the economic value

[1] See Chapter XLVII for data in regard to school attendance.

that they formerly had. This change in the economic status of children is unquestionably a very important factor in the declining birth rate.

Another important element in bringing about the decline in the birth rate is what may be broadly termed the Woman's Movement. This is part of the general democratic movement which has been under way in Europe and America during the past century. Politically and socially the married woman was something of a chattel to her husband a hundred years ago. Her property at marriage became his, and his voice at once became one of authority. The promise to obey was not an idle one. As Professor Wolfe puts it, "One can read the *Essay* from cover to cover without encountering a passage which indicates that Malthus ever thought that women have anything to do with population." Choice was reserved to the man. The past several decades have wrought a great change in this respect. The independence of women has been greatly increased. Business and professional opportunities have made them far less dependent on marriage than was true formerly, and in the marriage state, the pains of childbirth and the care of children have come to be matters of conscious choice with ever increasing numbers of city women.

The urge to parenthood is so strong that a child or two is desired by perhaps almost all women, but there is an increasing preference to bear but few. Further, the attitude of preference for a small family is fast becoming part of our social mores. In this as in other phases of life custom is important. There are styles in sizes of families as definite as in the shapes of hats. And the present mode is the small family. To an increasing degree it is not good form to have a large number of children. The contrast between the social attitude in respect to this matter in the pioneer communities of a century ago and that in a modern city community, is most marked.

One important supplemental factor to the above considerations is the increased knowledge of contraceptive methods, or of birth control. There is considerable opposition in some quarters to the dissemination of such information, but despite this the

knowledge of such methods is apparently more and more widespread. Some observers say that such knowledge has only recently been rather widely extended among the poorer groups, and that it is to be expected that the birth rate among them will more nearly approach that which has long prevailed in the more well-to-do groups. One who is interested in the elimination of poverty, or in its reduction, cannot well fail to rejoice that it is increasingly possible for the poorer families to restrict the number of their children.

As suggested in the earlier chapter that dealt with this subject,[1] it is possible that the modern industrial life has reduced fecundity to some extent. Thus this may be a factor in the declining birth rate. But the most significant factors are, it seems, the ones that have been emphasized above.

Migrations. — A discussion of the population question raises the issue of the migration of people from one area to another. Throughout history, overcrowding in one district has led to a movement into areas that were less densely crowded. The people of all the centuries have acted on a knowledge of the law of diminishing returns. This situation has menaced, and still menaces, the peace of the world. The question thus arises as to whether the people of one area can restrict their numbers and maintain a high state of living, and protect their standard from the encroachment of the more rapid breeders outside their boundaries.

Under certain conditions this can be accomplished, as in the case of the United States at the present time. Undoubtedly the people from southern Europe and Asia would inundate our land if permitted to do so. Our exclusion laws are keeping them out, but in the long run such laws may not be effective if the swarms of people desiring admittance continue to increase. Pressure of population, if other areas are less crowded, leads to wars of conquest and victory tends to go to the more numerous. The outlawry of war and leagues of nations to keep the peace may operate as checks on such processes, but over a long period of time the resources of the world cannot be very unequally

[1] Chapter VII.

divided among the population of the world. Hence, the ability of one people to maintain a high state of living for themselves tends to depend upon the desire of other peoples to do likewise. In other words, the welfare of the people of the United States during the next century or so will turn upon the birth rate in other countries. And this will be determined by whether a desire for economic welfare is developed to such a point that control will be exercised. It follows then that the creation of economic wants among the rapidly increasing peoples is of prime importance. The commercial salesman and not the missionary may prove to be the agency that will save Christian civilization.

United States Immigration. — The United States has been peopled almost exclusively by immigrants and their descendants. From 1820 to 1925, almost 37,000,000 immigrants entered the country. Two-thirds of the present population are either foreign-born or born of parents of which one or both were born abroad. In the colonial and early national period there were no restrictions upon entry into the country. State regulations prevailed for about fifty years (1830–1882), during which time there was some national legislation affecting the transportation of immigrants. In 1882, Congress enacted a law excluding Chinese, and from that time on the restrictions have become more drastic. In 1924 an act was passed that limits the number of persons from any European nation to 2 per cent of the number of foreign-born persons of that country who were residents of the United States in 1890, but a minimum of 100 may be admitted from any of these nations. This law provided that the classification should be later changed from a national to a racial basis, but the impracticability of a racial classification has caused Congress to extend from time to time the date for the expiration of the national classification. Persons from the Orient, with some exceptions, are excluded under other laws. There are no quota restrictions so far as people from the western continent are concerned. They may be excluded, if at all, only on the basis of health, criminality, or other unfitness prescribed in the laws.

In the two decades, 1841–1860, 93 per cent of the immigration came from northern and western Europe and less than 1 per cent from southern and eastern Europe. But in the first decade of this century only 21.7 per cent came from the former section, and 70.8 per cent from the latter. The quota law, which was first adopted in 1921, is designed to check the number that enter the country from the southern and eastern parts of Europe. The result of this is reflected in the fact that 23,118 came from that section in 1925 as compared with 125,248 from the northern and western parts of Europe. These were 7.9 per cent and 42.8 per cent respectively of the total immigration. Almost 35 per cent of the immigrants of that year came from British North America.

It is claimed in many quarters that the people from the southern and eastern parts of Europe are inferior biologically to those from the northern and western sections of that continent. Differences of this kind, however, have not been scientifically established, in the opinion of some of the most careful students. Modern scientific thought on this question emphasizes the importance of social environment and gives but little credence to inborn traits. Perhaps the social environments of the people of the two sections are such that persons from the one region will more probably become good citizens of the United States than will persons from the other sections. It is only in such considerations, if at all, that a basis can be found for different treatment among these peoples.

The effect of the more drastic exclusion policies of recent years is shown by the following data. In each of the five years preceding the outbreak of the World War the total number of aliens admitted to the country was over 1,000,000, and in 1913 and 1914 almost 1,500,000 for each year. Something less than 200,000 of these, except for one year, were non-immigrants, that is, aliens en route through the country or coming for a temporary period. Subtracting the number of aliens that departed from the number that came the net increase from immigration is found to have reached almost 1,000,000 in 1913 and in 1914. In contrast with these figures the total admissions in 1925 and

1926 were less than 500,000, and counting out the aliens who left the country, the net increase for each of these two years was less than 300,000. Approximately 100,000 of those admitted in these two years were from British North America, and over 30,000 were from Mexico. As remarked earlier, it is estimated that about 175,000 aliens enter the country illegally each year. Some of these are members of ship crews who desert their vessels here, and others are smuggled over the Canadian and Mexican borders.

Do We Need Immigrants? — In the discussion of the problem of immigration, the point is very frequently made that we need the immigrants in our industries. An interesting question arises as to what persons properly constitute the *we* in this statement. The owners of mines, factories, and certain types of farming land do always *need* such labor. It is usually very cheap relatively to native labor and it is desired in order that profits may be augmented. The consumers of such products may also profit from the use of such labor by the employers, as competition among them may reduce the prices of products somewhat. But certainly the wage earners of this country do not need the extra labor from abroad. The influx of foreign laborers can only result in lowering wages. Further, in so far as such persons cannot easily be brought into trade unions, their presence is all the more depressing to wage standards.

Considered broadly, the question of the influx of foreign laborers involves the question of the effect that their addition will have upon the average economic output. It also involves the social consequences of a reduction in wages for the major portion of our population. Further, the question of the effect of large groups of foreigners upon the political and social conditions is also to be considered. Clearly, the gain to employers may be far more than offset by losses in other directions. The most important economic tasks tend to be done by a given population. If certain work cannot be done because of a lack of laborers, the chances are that it can well be left undone. If waste places can be farmed only by importing foreign laborers, the situation calls for rejoicing that numbers are so few relatively

to resources that such places need not be used. If certain mines can be operated only with cheap imported labor, this is an indication of well-being which it would be a travesty to destroy by adding numbers and forcing down the marginal productivity of the nation so as to make it possible to work such mines. If certain factories can be run at a profit only by importing low wage labor this means that other lines of employment are more profitable; that in view of the opportunities that confront the population, the one line of work cannot be carried on. A wise population policy calls for such an adjustment of numbers to resources that inferior lands and mines will lie unused, and certain products will be imported from the more overcrowded countries.

PROBLEMS AND EXERCISES

134. Define the term *diminishing returns.*

135. If the population of the United States should double every 25 years during the next 100 years, what would the density be per acre? If this rate of increase should go on for 200 years?

136. Name several factors to account for the marked difference between living conditions during the Middle Ages and those that prevail now.

137. President Harding wrote a letter in 1921 congratulating a woman in New York who was the mother of 16 children. He thus implied that all women should bear this many children. Compute the increase that would take place in our population during 50 years if this were done.

138. Give several reasons to account for the fact that an increase in the population is usually approved.

139. "The desire for economic goods has displaced the desire for large families." Discuss

140. "The real enemy of the dove of peace is not the eagle of pride or the vulture of greed but the stork." E. A. Ross. Develop an argument in support of this statement.

141. "America could never have finished its transcontinental railroads, developed its coal and iron deposits, operated its furnaces and factories, had it not drawn upon Europe for its labor force; for it was impossible to secure 'white men' to do this work." P. Roberts. Compare with the discussion above.

REFERENCES

Population Problems in the United States and Canada, 1926, is a collection of nineteen essays, dealing with various aspects of the population problem. It is edited by L. I. Dublin. The importance of stressing the optimum population is developed by A. B. Wolfe in one of these essays. E. M. East, *Mankind at the Crossroads*, 1923, emphasizes the idea that population is encroaching upon subsistence. E. B. Reuter, *Population Problems* contains much valuable material.

For a comprehensive discussion of immigration see *Immigration*, 1925, by H. P. Fairchild.

Articles upon the various phases of the population problem appear frequently in the various journals and magazines.

CHAPTER XLVI

AGRICULTURE

The agricultural industry is usually given a great deal of attention in the various nations. It is almost universally "coddled." The basic need for food is one element in this, and another is something of a poetic regard for rural life. Still another factor is the rather numerous political votes of the farmers. The situation in the United States is not exceptional. The farm problem bulks large with us.

The Agricultural Depression. — For the past several years the interest in agriculture has been especially marked. This has been due to the fact that the agricultural industry in the United States, and also abroad, has been in a state of depression since the termination of the World War. It is not difficult to state in general terms the reason for this condition in agriculture. The analysis in several of the preceding chapters points inescapably to an explanation of the agricultural depression.

Our economic system is composed of many different kinds of industries and each industry represents the work of many competing units and in some lines of work as, for example, farming, the number of individuals who are separately engaged in production is legion. Any one of the various industries will enjoy prosperity if the other industries make such strong demands upon it that in view of its ability to supply the quantity demanded high prices can be secured. The firms supplying building material prospered greatly as a result of the demands of building contractors during 1922–1926, and to use a negative illustration, iron and steel firms experienced a slump in prosperity in the summer of 1927 because of a decline in building construction and a decline in automobile manufacture. In general, then, the prosperity of one industry depends upon the

demands of other industries. If the outputs of the various industries have a certain relationship to each other they may all enjoy a high degree of prosperity. But if the demand for the product of any one of a group of industries should fall off, or, if without any change in the demand, the supply should be greatly augmented, the price of products in the lines affected would fall. Unless there have been corresponding decreases in the cost of production, this would necessarily mean a reduction in profit to the firms concerned and this might be sufficient to result in great losses.

The explanation of the depression in agriculture is indicated by this analysis. The supply and demand relationships in respect to the products of the farms are such that the prices of farm products are low in relation to the expense of producing them. The expense includes wages of hired help, the cost of machinery and the interest on borrowed money and taxes. The following diagram shows the farm prices of 30 representative products and the average costs to farmers for the period 1914 to 1925, according to the National Industrial Conference Board.

It will be noted that the prices of agriculture products rose sharply during 1916 and 1917, and fell very precipitately during 1920. Costs rose less rapidly during these earlier years and this enabled the farmers to make enormous profits. But following January, 1920, costs fell much less than did prices and have since remained further above the cost prices of 1914 than the prices of farm products are above the 1914 prices. Relatively to 1914, the relation between prices and costs was seriously to the disadvantage of farmers from 1920 to 1925, as shown by the diagram.

One element included in these cost data is interest on the value of farm land. This is clearly part of the farmer's cost. But broadly speaking, the price of farm land is a result of the expected condition of farm prosperity. The causal sequence runs from the expected price of farm products to the expected net rent of farm lands and then to the price of farm lands. The price of farms can thus be determined by the expected prices in

farm products, but after a man has bought a farm, whether he will gain or lose will depend upon the prices that prevail for the articles which he produces in relation to the cost of producing them. Hence, as the prices of products fall, farmers who have bought land on the basis of former prices will lose money, and in many cases they will lose their farms to the persons who have loaned money upon them and taken mortgages as security. Distress and poverty will then prevail through the farming areas.

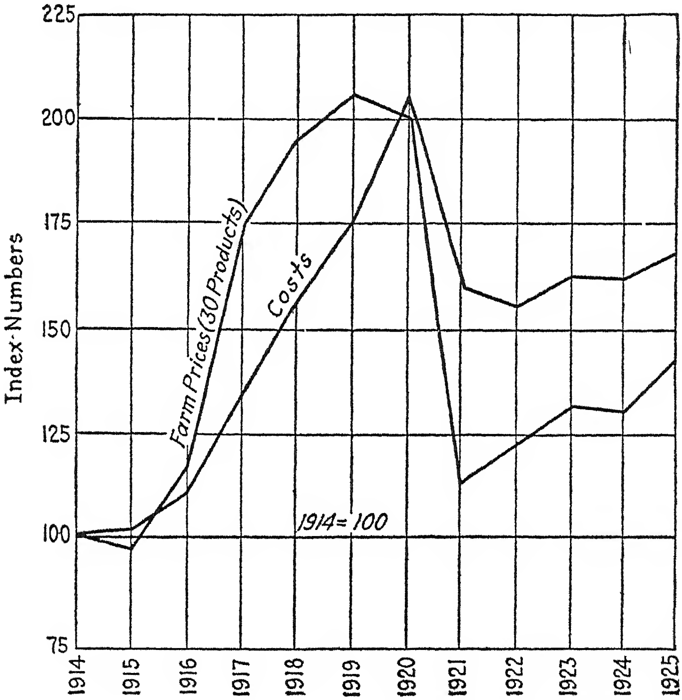

Chart IX. Farm Prices (30 products) and Costs, 1914–1925. National Industrial Conference Board, *The Agricultural Problem*, 1926, p. 106.

This was the case following 1920. Prices of products had been high as the above diagram indicates. The profits that were realized during and immediately following the war generated an enthusiasm that carried the prices of land to high figures. Farms were purchased at a very high valuation with some cash and much

borrowing. In Iowa, the increase in the price of farm land during this period is estimated to have been almost threefold, and for the country as a whole the value of farm land is estimated to have doubled from 1910 to 1920. These extremely high prices of farm land increased the expense to new buyers of running the farms at a profit. If a farmer was to come out even on his investment, it was necessary that the margin of price over total expense should remain as it was. But instead of this condition prevailing, the prices of products fell. The mortgage payments on large numbers of farms could not be met and mortgage holders claimed title under the law. Many farmers lost the savings of a lifetime, and many banks were driven into bankruptcy because of the loans they had made to farmers.

The following chart shows the number of bankruptcies among farmers relatively to the total number of bankruptcies in all

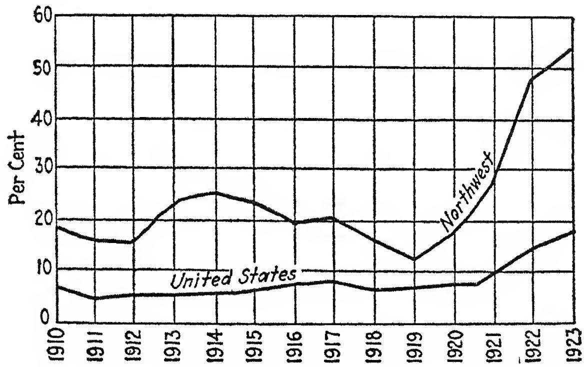

Chart X. Number of Bankruptcies Among Farmers Relative to Total Number in all Fields of Investments for United States and for the Northern Section. *The Agricultural Year-book,* 1923, p. 10.

fields of investment for the years 1911–1923, as given in the *Agricultural Yearbook* for 1923.

The increase in farm bankruptcies relatively to the total number of bankruptcies is especially marked after 1919 in the Northwest. As observed in the *Yearbook,* "the situation is only partially reflected in these figures, since farmers as a rule do not resort to the bankruptcy courts when surrendering property to creditors."

Why did the prices of agricultural products fall in 1920 and why have they since remained at low figures? First, the war demand which had prevailed carried prices to an inordinate height. Then following the war, during the calendar year 1919, there was feverish activity in many lines of industrial enterprises. The percentage of employment was very high, wages were high, the prices of products were also high and great profits were made by entrepreneurs. But by the early months of 1920, it appeared that as a whole the various industries were not so adjusted to each other that it would be possible to maintain the state of prosperity that then prevailed. It was seen that certain lines of industry had been extended far beyond the possibility of disposing of the products therefrom at a profit. It then became necessary to cut prices in these lines of industry, and as a result many firms failed and a spirit of pessimism was introduced which led to a severe depression. This change in situation among the manufacturing industries led to a great reduction in the demand for agricultural products and thus led to the break in the prices of farm products. This, however, only partially accounts for the continuance of the agricultural industry in the Slough of Despond. While the war demand for farm products and the demand during the post-war period of feverish business activity fell off sharply, there have also taken place significant changes in the supply side of farm products, and in the relation of agricultural exports to agricultural imports.

Second, there has been an increase in the efficiency of farm labor. Just what has been the rate of increase in efficiency cannot easily be determined. It has been estimated that from 1909 to 1919 the increase in agriculture efficiency was about 10 per cent; and in the five years between 1919 and 1924 nearly 11 per cent.[1] Professor Falconer has compiled the following figures from the records of the Ohio Experiment Station relatively to the cost of producing corn in Ohio for the two periods indicated.

[1] T. N. Carver, "Rural Depopulation," *Journal of Farm Economics*, January, 1927, Vol. IX, p. 4.

TABLE 4

LABOR REQUIREMENTS PER ACRE FOR CORN PRODUCTION IN OHIO [1]

	1907–1912 Hours	*1920–1927 Hours*
Seed bed preparation	6.97	5.15
Planting	1.21	1.08
Cultivation	7.00	4.22
Other man labor	20.82	14.55
Total	36.00	25.00

The decrease from 36 man-hours per acre of corn in 1907–1912 to 25 man-hours per acre in 1920–1927 is very marked. It amounts to a decrease of practically one-third. Or phrased differently, during the later period 25 hours of labor time resulted in the production of almost 50 per cent more corn than during the earlier period. In concluding his discussion of this, Falconer says, "Similar economies have been made in the labor requirements for producing other crops."

Further, improvements have been made in the yield of animal products per man-hour. Not only has selective breeding given us better stock, but better knowledge as to vaccination and disease prevention has reduced mortality. Thus, supply of agricultural products has been increased. On the demand side, the decline in the number of horses is a factor of no little importance. Professor Falconer gives the following data, in the bulletin quoted above.

TABLE 5

TOTAL CROP ACRES RELEASED IN OHIO [2]

By decrease in farm horses	695,880
By decrease in city horses	448,641
By less feed on tractor farms	49,500
Total	1,194,021

The item last listed arises from the fact that horses on farms where a tractor is used are fed some 15 per cent less than are the

[1] J. I. Falconer, Ohio Agricultural Experiment Station Bulletin, January–February, 1927, Vol. XII, No. 1, p. 31. [2] P. 29.

horses where there is no tractor. This release of over 1,000,000 acres of farm products in Ohio as a result of the decline in the use of horses, has added approximately 10 per cent to the area of marketable crops in that state. The situation in the other states is perhaps closely comparable to this.

Another significant factor in the agricultural situation is the change in the volume of agricultural exports and imports. This is indicated in the following chart, which shows the change in physical volume per capita.

CHART XI. Changes in Per Capita Volume of Exports and Imports of Agricultural Products. National Industrial Conference Board, *ibid.*, p. 35.

The increase in the volume of agricultural imports and the decline in the volume of agricultural exports per capita since 1918 is very marked. This alone goes far to explain the agricultural depression.

Hence, the situation is that relatively to the demand for farm products the supply of such products is such that the farmers

are not able to secure high prices. Another phrasing of this is that in view of the present demand for farm products, there are too many farmers to permit any of them to secure the prices that would mean prosperity for them. A still different phrasing of this matter is that not enough persons have left the farms and gone into cities to engage in manufacturing to make it possible for farmers as a group to make money. There has been a movement away from farms recently. It has been estimated that there were 31.5 million persons on farms in the United States in 1920, but only 29 millions in 1927.[1] The United States Department of Agriculture gives the total farm population as 27,699,000 for January 1, 1928. The Department estimates that the farm population decreased by 193,000 persons in 1927, 649,000 in 1926 and 441,000 in 1925. Relatively to the total population the farm population has declined for several decades, but it is only within recent years that there has been an absolute decline in the number of persons on farms. Yet the number has not decreased sufficiently to permit the remaining farmers to prosper.

The disinclination of many farmers to discontinue farming and take up work in the cities can be easily explained. The farmers enjoy an independence of life as compared with the wage earners in a manufacturing establishment that is very pleasing to many persons. Further, the mere fact of having been conditioned to life on the farm makes many persons reluctant to try their fortune in the city and retards the movement away from the farm, even though the opportunities in the city may be much greater than the opportunities to get ahead in the country.

Further, there is perhaps no line of industry in which persons of mediocre or less than mediocre ability can get on so well as in the business of farming. This is an important factor in causing persons to resist the call of the city.

Lack of Organization Among Farmers. — Farmers are tra-

[1] *Report on the Agricultural Situation*, by the Special Committee of the Association of Land Grant Colleges and Universities, 41st Annual Convention, Chicago, Ill., November, 1927.

ditionally independent in spirit. They are inclined to live apart from one another, and tend to be suspicious of each other. Hence there has been but little coöperation among them. Further, the fact that there are so many farmers has been a significant factor in preventing coöperative organizations. The trade association movement among manufacturers which was discussed in a preceding chapter has been applied only to a very limited extent among farmers. Thus they have been unable to exercise that degree of control over output and over prices that has been exercised by manufacturers.

But a measure of progress has been attained recently in this field. "Nearly one-fifth of our agricultural business, or $2,500,-000,000 worth, was done this year (1925) through farmers' organizations."[1] This statement refers to the coöperative marketing associations. Ninety-five per cent of these associations are local organizations, but approximately one-third of the total business at the present time is carried on by one hundred of the federations and regional (non-local) organizations.[2] They are the dominant factors in coöperative marketing. Some advantages undoubtedly accrue from such marketing associations, but their importance to the farming industry can easily be overrated. If there is a relatively small group of producers, and if production is confined to a rather narrow locality, as in the case of California fruits, an association of growers may prove to be very profitable.

The California Fruit Growers Exchange has been very successful. Not only has it been able to control the flow of fruit on to the market, but it has been able to increase very greatly the demand for the fruit that it has to sell. But other marketing organizations have not been so fortunate, for the simple reason that they have not been able to control supply. Hence, any improvement in price, due to better marketing or to other reasons, tends to lead to increased production by non-members of the association, granting that members do not extend their crop area. This then leads to such a supply that the association is not able appreciably to influence price through

[1] *Agricultural Yearbook*, 1925, p. 17. [2] *Ibid.*, p. 19.

its marketing mechanism, and thus it no longer has any excuse for existence.

The Burley Tobacco Growers Coöperative Association, for example, was organized following the War and was one of the strongest and best managed of the coöperative marketing associations. But in the late autumn of 1927 it announced its inability to secure marketing contracts for 75 per cent of the 1926 crop and proposed discontinuance for the selling season of 1927. Coöperative marketing organizations for still more widely grown products, such as wheat, corn, and oats, could surely have but little if any effect on price.

Freight Rates. — One item of significance to farmers is the level of freight rates. The United States Secretary of Agriculture says that in September, 1925, the level of farm prices was 144 per cent of the pre-war average, whereas freight rates on agricultural commodities were 158 per cent of the pre-war average. The post-war increase in freight rates was made just as the prices of farm crops started to fall, and this contributed further to the agricultural depression.

The adjustment of freight rates so that the railways will prosper, and so that other lines of industry, including farming, will not be adversely affected is an intricate problem, as has been indicated in an earlier chapter. It would clearly be socially inadvisable to carry the crops of the country at a loss to the railroads. This would mean a loss to other industries.

The Grain Futures Administration. — The farmers have long looked with suspicion at the organized produce exchanges. Unfavorable price movement has very frequently been attributed to the speculators in the markets. This attitude has been largely unfounded, as has been implied in the discussion in preceding chapters. Short selling tends to depress price, as the agriculturists contend, but buying to cover the short contracts tends to raise price. The data in Chapter XXIV clearly show that during the years indicated the speculators did not, as is so often charged, lower the price at crop selling time and raise it later.

It is reasonable to believe, however, that over short periods

of time speculative operators who buy and sell large quantities of produce may cause the price of a product to rise and fall. In the hopes of accomplishing something by way of reducing price fluctuations, Congress provided, a few years ago, what is called the Grain Futures Administration, to be directed by the Department of Agriculture. The buying and selling on the markets are carefully recorded by this agency and special investigations are made when the price fluctuations are especially marked. Partly as a result of this work, and of the latent power of the Grain Futures Administration, the exchanges have taken steps to prevent marked fluctuations in prices from day to day.

Packers and Stockyards Administration. — Congress has also provided for a separate unit of administration in the Department of Agriculture to supervise packers and stockyards. The aim of this administrative unit is "to promote fair, impartial, open, and competitive conditions in the livestock and meat-marketing process of the country." [1] Investigations are conducted, books of marketing agencies are audited, suggestions are made as to suitable rates of commission, bonds are required from buyers to assure payment for stock purchased, and in other ways attempts are made to secure fair treatment to farmers.

Research. — The national Department of Agriculture also engages in very extensive research in respect to methods of growing products, diseases of plants and farm animals, the development of new products, and harvesting and marketing. In addition to such work by the national department, state departments also do much work of this character. Further, in the dissemination of news in regard to prices, market conditions, and weather the national Department of Agriculture performs very valuable service. This work is of very great significance to the nation as a whole. But on account of the increase in product which has resulted therefrom, it has contributed to the losses which some farmers have experienced recently.

The Tariff and Agriculture. — Our protective tariff which has prevailed throughout our national life is very largely designed

[1] *Yearbook, ibid.*, p. 38.

in the interest of manufacturers, and it has contributed appreciably to profits in many lines of manufacturing. This has come, as was explained in Chapter XXXIV, through keeping out the manufactured products of foreigners and thus permitting American manufacturers to receive higher prices than they would otherwise have been able to get. Throughout the tariff history, claims have been made by the tariff advocates that the farmer received substantial benefits as a result of this policy. But a protective tariff can be of advantage to an industry only in case foreign goods are excluded that would otherwise be sold in the home markets in competition with home products. So far as our agricultural industry as a whole is concerned, agricultural products have been exported during our entire history. Generally speaking, there has been no competition in local markets with foreign agricultural products. Hence the tariff policy cannot, so far as the whole group of agricultural products is concerned, have been of benefit to American agriculture.

Furthermore, the tariff has tended to be of direct disadvantage to American farmers for two reasons. In the first place, it has resulted, as already indicated, in making prices of manufactured products higher than they otherwise would have been. Hence, the purchases that the farmers have had to make as producers and also as consumers have been increased as a result of the tariff on manufactured products. Second, the tariff, by cutting down the importation of manufactured products, has restricted the sales which foreigners could have made in our markets. This has meant that foreigners were thereby restricted in their purchases from us. In short, since the tariff curtailed the sale of manufactured goods to foreigners, it at the same time curtailed the purchase of agricultural products from America. The tariff policy has thus not only failed to benefit agriculture directly, but has affected it adversely indirectly.

The situation of American agriculture in respect to the tariff policy can also be illustrated by reference to the situation in England. In England following the Napoleonic wars, tariff duties were instituted upon the importation of food products. These tariff duties became known as the "corn laws." During

the 1830's and early 1840's, a vigorous campaign was carried on in England looking toward the repeal of this legislation. The advocates of the removal of these tariff duties were finally successful and the laws were repealed in 1846. These tariff duties were clearly to the advantage of the landowners in England. Food products were imported into England rather than exported from England. Hence the tariff duties permitted prices of farm products to be higher than they otherwise would have been. This situation, to repeat, was just the opposite of that which has always prevailed in the United States. Here we have been exporters of agricultural products and thus it has been impossible for tariffs on farm products to raise the prices in our markets above the prices which would otherwise have prevailed.

From the point of view of the many individual articles of farm production, there are some exceptions to the above analysis. In the tariff act of 1922, duties are provided for something over one hundred agricultural products. On some of these articles the tariff is effective. This is true of sugar, flax, lemons, peanuts, almonds, walnuts, wool, and clover and alfalfa seed. The tariff is partially effective on hay, rice, potatoes, mutton, beef, dairy products, certain grades of wheat, and certain types of tobacco.[1] But so far as major farm products, such as wheat, corn, oats, barley, cotton, and pork products are concerned, American farmers are exporters and it is absurd to believe that the tariff can be of any benefit to them whatever. The effect of the tariff on wheat was given special consideration, it will be recalled, in Chapter XXXV.

Proposed Measures for Farm Relief. — Whenever an industry is in the condition that the farming industry has been in for the past seven years, it is to be expected that demands will be made for legislation designed to improve conditions. This is especially to be expected if the persons concerned represent a large number of voters, as is true of farmers. One kind of legislation designed to benefit the farming industry has to

[1] *Report on the Agricultural Situation* by the Special Committee of the Association of Land Grant Colleges and Universities, 41st Annual Convention, Chicago, Ill., November, 1927.

do with money and credit. As was indicated in Chapter XXX special legislation has been designed to make it possible for farmers to borrow money at lower rates than would otherwise have been possible.

The interest of the farming sections in the banking system led to a demand during 1923–1924 for representation of farmers on the Federal Reserve Board. Legislation was passed in the summer of 1924 enlarging the Federal Reserve Board by one, the understanding being that the President would appoint a "dirt farmer" to fill the position thus created. At the same time vigorous opposition was offered to the reappointment of the governor of the Federal Reserve Board, W. P. G. Harding, whose term of office expired at that time. The complaint of the farming group at this time took in part the form of criticism of the Federal Reserve Board for the stiffening of money rates in 1919 and 1920. The idea expressed was that the Federal Reserve Board had deliberately caused the break in prices which came in the early part of 1920. Careful observers point out, however, that the board erred in delaying so long to advance the rates. Many proposals have also been made during the past few years for marked increases in the amount of money. Some of these are patently absurd.

One interesting form of proposed legislation was embodied in the McNary-Haugen bill, which passed Congress in February, 1927. The bill was vetoed by the President and thus did not become a law. The plan contemplated the creation of a commission whose duty it should be to buy a sufficient quantity of farm products to raise the prices of such products to satisfactory levels. The amount that was thus to be purchased was to be disposed of abroad by this commission at any price that could be secured for it. The plan also provided that tariff duties should be imposed in order to prevent such produce as was sold abroad from being reimported into the United States. This plan meant, of course, that the produce which the commission thus bought up could not be sold abroad at the prices which were paid for it. Hence it was inevitable that a deficit would be incurred. To make up this deficit, it was proposed that the

various farmers should be compelled to pay a sufficient sum of money in the form of fees to make up this difference.

This plan had certain obvious weaknesses. In the first place, it was to be expected that the foreign nations would strongly resist such an attempt on the part of the United States Government to sell products in their market at low prices. While such sales in London, for example, would have been decidedly beneficial to the city population of England, it is inconceivable that the farming groups would not have objected bitterly to such sales. It is to be expected that their protests would have been effective in causing the government to take steps to prevent such dumping on the part of the American government. Likewise, the farming interests in other countries would also have risen in arms against this cut-price policy on the part of the American government. Second, as the plan would have been temporarily successful in raising the prices of American farm products this would have led to an increase in production, and as a result of this, the commission would have been called upon to purchase an ever increasing quantity of products in order to maintain the price which was deemed to be reasonable.

In the discussions of this bill, it was alleged by Secretary Mellon of the Treasury Department, and other administration leaders that the plan should be sharply condemned because it would result in raising prices to American consumers, and would permit Europeans to buy American products cheaper than Americans at home were able to buy them. This undoubtedly was the effect which was contemplated by the sponsors of this legislation, but the same effects result, and always have resulted, from the protective tariff so far as manufacturing is concerned. The selfishness of the farmers in this proposed legislation is not more to be condemned than is the selfishness of Mr. Mellon and other manufacturers who have always stanchly supported a protective tariff on manufactured goods. But the fact that the farmers are no more selfish in their demands than the manufacturers have been, does not make the proposal a good one. Further, the plan is impracticable, as suggested above, for

reasons which do not apply so far as the tariff on manufactured goods is concerned.

As indicated at the outset of this chapter, the market weakness in the farming industry comes because of a maladjustment of this industry with other industries of the country. What is needed is that the supply and demand relationship be corrected through some decrease in the output of farm products. The possibility that relief might be secured through lowering the expense of farming is not bright. The prices which farmers must pay for the things which they buy are determined in broad markets. Marked reductions in prices of machinery, farm labor, etc., are not to be expected. Relief must thus be looked for through a reduction in the supply of products. Some relief may be expected through a better coördination of marketing facilities. But relief through this door would come principally from a curtailment of production.

Incidentally, the present situation in the farming industry shows that the pressure of the population upon resources is not so marked to-day as it was a few decades ago, thanks to a decline in the rate of population increase and to improvements in methods. Perhaps at the close of another quarter century the situation will be different. This suggests again the conflict of interest among the different economic groups. The landowning — the natural resources owning — portion of the population gains at the expense of other groups as the margin of land utilization is forced down. And the margin is lowered as a result of the more intensive utilization that results from an increase in numbers. Similarly, landowners lose as the pressure upon resources is relieved. This, to repeat, is what has happened so far as pressure on agricultural land is concerned, during the past few years.

PROBLEMS AND EXERCISES

142. Is the analysis in respect to the agricultural depression in line with that in the chapter on business cycles? Discuss.

143. How does the analysis in this chapter of the increased efficiency in agriculture fit in with the discussion of the population question in the preceding chapter? Discuss.

144. Note the limitations to the benefit to be derived from coöperative selling.

145. Discuss the effect of the tariff on wheat. See Chapter XXXV.

146. Account for the increased degree of "government interference" in the agricultural industry.

147. Contrast the practicability of the McNary-Haugen proposal and a tariff on manufacturing. Compare the intended results of the one with the results of the other.

REFERENCES

The United States Department of Agriculture publishes a large mass of material dealing with this subject. The *Agriculture Yearbook* is especially valuable. Among the many recent books dealing with agriculture are B. H. Hibbard, *Marketing Agricultural Products*, 1921; G. G. Huebner, *Agricultural Commerce*, 1924; E. G. Nourse, *American Agriculture and the European Market*, 1924; H. C. Taylor, *Outlines of Agricultural Economics*, 1925; and G. F. Warren and F. A. Pearsons, *The Agricultural Situation*, 1924.

PART VIII

PUBLIC FINANCE

CHAPTER XLVII

PUBLIC EXPENDITURES

I. Public and Private Economic Activity

The Economic Activities of Government. — The point has been frequently emphasized in the preceding portions of this book that the rôle of the political government is a very significant one in our economic system. While our system is one of private property — of individual initiative — organized political government is a necessary part of it. Not only does the political government perform the important but elementary function of maintaining law and order, it has also become the principal agent for the carrying on of certain projects such as the maintenance of schools and the building of roads. Furthermore, as the economic interdependence of individuals has increased, the scope of government has been constantly extended through the necessity of having to provide rules and regulations for the conduct of individual enterprises, and commissions for the enforcement of these rules and regulations. As the scope of the government's activities has thus been increased, it has obviously been necessary to allocate a larger volume of economic goods and services to the government, for without them these functions could not be performed. In terms of our modern life, the government must have money in order to carry on its work. How society shall provide this money for the governing body, and safeguard its expenditure is an important economic problem.

The Totality of Our Economic Life. — The man of the street, and as well many an economist, speaks of the government as if its work were apart from our common economic life. We are frequently reminded of the cost of government to-day as compared with an earlier period, and, likewise, are often told of the

large portion of the total national income that is taken by the government. Such statements often seem to imply that the government, which is supported at great cost, does not render significant service. Indeed, some of the statements in regard to the cost of government imply that the government is related to the people of the country as would be a foreign government to which we were compelled to pay tribute. The statements and comparisons referred to are couched in language similar to that which the Germans might well use in reference to the amount of money which the allied nations are endeavoring to collect from them in the form of war indemnities. This is clearly not a correct picture of the relation between the body of the citizens and the government, in this or any other country.

The Totality of Our Economic Activity. — The economic activity of the people of a nation is divisible into two parts. Most persons who engage in economic activity work at private account — farming, manufacturing, building houses, selling goods, practicing medicine, acting on the stage, preaching, etc.; but a very large number make their contributions to the common economic welfare by working at government account — delivering mail, building roads, teaching school, inspecting factories, regulating the rates of public utilities, combating agricultural pests, judging cases at law, building battleships, policing cities, and so on. The last named groups of persons are engaged in economic activity as clearly as are the members of the first group. The difference between the two is merely that the one kind of activity is undertaken by private initiative and the other is undertaken at the initiative of the government. Between the two kinds of work there is no sharp line of demarcation, although with us government activity is seldom, if ever, resorted to except as a result of the shortcomings of private enterprise. But to repeat, the economic activity of government officials and government employees is as much a part of our total economic activity as is that of farmers and manufacturers.

The Total Economic Income. — Similarly, the total economic income of the people of the nation is not reduced by the amount

which is paid in taxes unless the government pays out the sums collected in foreign indemnities or indulges in wasteful expenditures. In other words, if taxes, barring foreign indemnities, are properly spent they yield an income to the people of the nation. The ultimate forms of economic income are the services yielded by economic goods or performed by persons. In terms of the familiar distinction used in the case of wages, we may distinguish between *real income* and *money income*. Real income consists of services, as contrasted with money income in the form of dollars or other monetary units.

Some of the bridges across rivers in this country are privately owned and a toll is collected by the persons who use them. They thus yield money income to the owners and real income, in the form of transportation services, to the public. The publicly owned bridges that may be used without charge yield real income as do the toll bridges, but there is an absence of money income. The railroads of the country bring a large money income to their owners, but the real income flowing from the publicly owned streets and country roads is of exactly the same nature as the real income of the railroads. Similarly, public schools, libraries, parks, and museums that are open without charge to the use of all persons yield income as do those for the use of which fees are charged, although only the latter bring in money income.

The real economic income of the people of the nation thus consists of two parts — one part flowing from private enterprise and the other from government enterprise; one part is paid for directly by consumers and the other part is paid for by taxpayers. Taxes are *burdens* to the persons paying them, but from the point of view of the whole society, or nation, they merely represent collective payments to the persons who as government officials or government employees perform services for the benefit of the general public. Taxes are burdens only in the sense that grocery bills are burdens. Both are necessary in a community where the degree of economic interdependence is marked. The one insures police and fire protection, schools, courts, and regulatory boards and commissions. The other

secures the food that is produced by farmers and manufacturers, with the assistance of transportation companies, bankers, and merchants. The fact of specialization — of economic interdependence — makes each payment a necessary part of the expenditure of most persons.

The Proportion of Government Activity. — As has been noted frequently in the above pages, government activity has increased considerably during the past one hundred and fifty years, and within the past few decades the increase has been marked, as the degree of economic interdependence has become more pronounced. The following table gives the conclusions of the National Industrial Conference Board in regard to the total government expenditures in the United States for specified years, and the relation of these amounts to the "national income."

TABLE 6

TOTAL GOVERNMENT EXPENDITURES IN THE UNITED STATES[1]

	Total (millions)				*Per Capita*			
	1890	1903[2]	1913	1923	1890	1903[2]	1913	1923
Federal.	$ 291	$ 475	$ 692	$ 3,459	$ 4 61	$ 5.87	$ 7 17	$ 31.26
State	77	182	383	1,450	1.22	2.26	3.97	13.10
Local	487	913	1,844	5,136	7.72	11.27	19.10	46 41
Total	$855	$1,570	$2,919	$10,045	$13.56	$19.40	$30 24	$90.77
National income	$12,082	20,500	34,400	67,000	$191.61	$253.14	$356.43	$605.44
Ratio of total expenditures to national income	7.1%	7 7%	8.5%	15 0%	7.1%	7.7%	8.5%	15 0%

As the first portion of this table shows, government expenditures were greatly augmented during the thirty-three years under consideration. For 1923, the total is almost twelve times that for 1890. It must be kept in mind, however, that three significant factors must be considered in comparing the figures for these years; namely, the extent of the population, the level

[1] The Industrial Conference Board, *Tax Burdens and Public Expenditures*, 1925, p. 34.

[2] Some expenditures are for 1902 and others for 1903. United States Census Bureau figures for 1890 and 1902.

of price, and the wealth of the country. There were marked increases during these years in each of these three factors. The change in population is allowed for in the second part of this table. The data indicate that the government expenditures per person increased approximately sevenfold during the thirty-three years under review, although the total increase was twelvefold. Further, the general price level is estimated to have practically doubled during this time.[1] Thus in terms of the prices of 1890, the per capita increase is only one-half of the amount shown in the table. In other words, the per capita expenditures for 1923 are only three and one-half times those of 1890, if correction is made for the change in the price level. Then, too, if we consider the increase in expenditures in terms of the increase in that portion of the national income that flows from private enterprise, we find that the increase in public expenditures is still further reduced in importance. This relationship is shown in the table. The figures therein for "national income" indicate income from private enterprise, not the total national income which includes real income from government activities. The data given show the portion of the total private income which went to governmental work to have been 7.1 per cent in 1890 and 15 per cent in 1923.

In conclusion, then, the total public expenditures in the United States in 1923 were twelve times what they were in 1890 in terms of dollars; but only seven times as much per capita in the later year as in the earlier one; only three and one-half times as much per capita if the difference in the value of money is considered; and only twice as much per capita on the basis of the ability of citizens to support public projects. But even so, the volume of public expenditures to-day, and their growth during the past thirty-three years, are very significant. Ninety dollars per person for every man, woman, and child in the country — 15 per cent of the total private income — is a very considerable amount to devote to public enterprise. And, to repeat, the

[1] The index numbers of the wholesale prices of all commodities computed by the Bureau of Labor Statistics for 1890 and 1923 are respectively 76.1 and 142, on the basis of prices for 1913 as 100.

proportion of our economic energy that is devoted to government activities is steadily increasing. The increase in the degree of economic interdependence makes this imperative; the growth in the general economic efficiency of the people of the nation makes it possible; and the increased development in the social conscience further encourages remedial public activity. How far the movement will go, cannot be foretold. It is idle to lay down rules, as some writers have done, as to the proportion of our economic activity that can properly be expended under the direction of the government. The circumstances of the time, which include the disposition of the citizens, will determine the course that will be taken in this, as well as in other aspects of our social life, from decade to decade.

Government Activities in Other Countries. — The growth in government activities is not a phenomenon which is peculiar to the United States. In all of the European countries we find similar large increases in the volume of government expenditures, or in other words, in the scope of government activities. Indeed, in the European countries, government activity has been extended far more widely than it has in the United States. In these countries we find the governments engaging in commercial enterprises that are exclusively in the hands of private persons in this country. This was emphasized in Chapter XL, "Government Ownership," and a quotation was given there enumerating some thirty lines of enterprise in which foreign countries are participating. It is perhaps reasonable to believe that this list will be increased rather than contracted in the future. Then even out the tax load.

II. The Distribution of Public Expenditures

An interesting question arises as to the purpose for which government expenditures are made, or in the terms used in the opening paragraph of this chapter, the question is as to the services that are performed by the governing units. The nature of government activity necessarily varies from one governing unit to another. Federal activity is very different from that of the states, and that of the states from that of the

cities, and the activities carried on by the cities differ in turn from those of the counties and townships. Further, it is improbable that the efforts devoted to the various government activities are proportioned in exactly the same way in any two states, cities, or counties.

It may be noted by reference to the above table that over half of the total government expenditure in 1923 was made by the local governing units, cities, towns, counties, and townships. The states and the local governments together spent two-thirds of the total, and the national government only one-third.

National Expenditures. — *War.* — The expenditures of the national government are largely concerned with military and naval matters, including the payment of the public debt, which was incurred almost entirely as a result of war, and the payment of pension and other war claims. Approximately, three-fourths (75 per cent) of the total national expenditures in 1924 were for such purposes. Out of a budget of almost four billion dollars, something less than three billions thus related to past wars or to probable future wars. This was approximately 30 per cent, almost one-third, of the total government expenditure, federal, state, and local for that year. The proportion that war expenditures bore to the total federal expenditures in the year under review is not unusually high, in comparison with that of other years. In 1870, the expenditure for this purpose constituted over 80 per cent of the total; in 1880, almost 75 per cent; 1890, 66 per cent; and in 1900, 72 per cent.[1]

The elimination of war would thus greatly reduce the "burden" of government expenditure. If war becomes so destructive that nations can no longer engage in it without the danger of mutually destroying each other — and competent critics say that this is now true — it is possible that the Christian nations will forswear this ancient sport to the relief of the budgets of the future. This, however, is problematical. The spirit

[1] C. J. Bullock, "The Growth of Federal Expenditures," *Political Science Quarterly*, Vol. XVIII, p. 97.

of nationalism may be too strong to permit peoples to abandon the sovereign right of making war. Hence, strong nations, including our own, may never have their budgets reduced in this wise, but may, instead, elect to permit civilization to destroy itself in military combat.

Pensions. — The payment of pensions to ex-soldiers and their widows is a significant part of the cost of wars. First, there is the general disposition on the part of the public to be generous with the persons who have been disabled in war. Second, political pressure can easily be exerted upon Congressmen to the end that pensions are granted regardless of the disability of the ex-soldier or the need of soldiers' widows. Strangely enough, men who take great pride in their patriotism and in the fact of their devotion to the country's interest during a war, are, for the most part, willing to take advantage of every opportunity to become a charge upon the public treasury. Not only have ex-soldiers been at fault in this, but widows and other dependents as well. Congress has "corrected" the military records of thousands of persons in order to make them eligible for Civil War pensions. It was not until 1878 that the last law relating to the payment of pensions for the Revolutionary War was passed, and not until 1910, 127 years after the termination of the conflict, that the payment of pensions in respect to it ceased. On this basis we shall still be paying Civil War pensions in 1990.

The total pension bill for the Civil War is already over 5 billion dollars, and by the year named will reach 10 billions if no change is made in public policy in this respect. It is interesting to note in this connection that the cost of conducting the Civil War was 3 billion dollars. The pension charge to date is thus almost twice the cost of the military operation, and we are perhaps not yet half through with these payments.

It was hoped at the time of our entrance into the World War that the pension evil in politics might be avoided so far as this war was concerned. Accordingly, provisions were made for compensation in the case of disability or death of a soldier. One feature of this was provision for life insurance policies.

But despite these precautions, many of the states have given bonuses to World War veterans, and in 1924, a federal bonus bill was passed over the veto of the President. This provided cash payments to those who, under the schedule adopted, were entitled to sums of less than fifty dollars; and to the other ex-soldiers, life insurance policies were given. Banks in the Federal Reserve System were required to loan money on the policies up to 90 per cent of their surrender value.

This law is so obviously a makeshift that it has been suggested that perhaps the Congressmen voting for it were really more concerned with job insurance for themselves than with life insurance for veterans.[1] We may confidently expect that additional grants will be demanded from the public treasury, and that they will be given, unless Congressmen should acquire a degree of courage in the face of would-be pensioners that they have not yet had.

The Civil Functions of the National Government. — Science and research work on the part of the national government amounted to one-fourth of 1 per cent of the total expenditure in 1924; public works, 5.8 per cent; marine transportation, 2.4 per cent; promotion of public health, 0.4 per cent; and promotion of public education, 0.3 per cent. Other somewhat similar items bring the total expenditures for civil functions to 12.5 per cent of the total national expenditure for 1924.[2]

State and Local Expenditures. — *Education.* — The largest item by far in the expenditures of state and local governments is education. In cities of over 30,000 population, 38 per cent of the government expenditure, not including expenditures for public service enterprises such as water supply, was devoted to schools in 1924. In 1903 the corresponding figure was 29.3 per cent. The percentage of the expenditures of the state governments that was devoted to schools was 36.8 in this year. In 1925, the figure was 38.2. Considering all of the state and local units of government of the country, the money devoted

[1] H. L. Lutz, *Public Finance*, 1924, p. 59.

[2] Industrial Conference Board, *Tax Burdens and Public Expenditures*, 1925, p. 37.

to schools is well over one-third of the total public expenditure.

The growth in the volume of school expenditures has been marked during the recent years, as the following table indicates.

TABLE 7

STATISTICAL SUMMARY OF ELEMENTARY AND SECONDARY SCHOOLS SUPPORTED AT PUBLIC EXPENSE.[1]

Year	*Per Cent of Children 5 to 17 Yrs. (Inclusive) Enrolled*	*Average No. of Days Attended by Each Pupil Enrolled*	*Per Cent of Pupils in High Schools*	*Total Expenditure*	*Total Expenditure per Pupil in Average Attendance*
1890	68.61	86 3	1.6	$ 140,507,000	$17.23
1900	72.43	99.0	3 3	214,965,000	20.12
1910	73.49	113.0	5.1	426,250,000	33.23
1920	77.8	121.2	10.2	1,036,151,000	64.16
1924	82.8	132.5	14.0	1,820,744,000	95.17

These data do not include normal schools, professional schools, and universities that are conducted at public expense, but only elementary schools and high schools. The total public expenditures for these schools, as shown by the table, increased elevenfold from 1890 to 1924, and almost doubled from 1920 to 1924. The price level increased by 100 per cent from 1890 to 1920, and this reduces the importance of the figure for 1920 as compared with 1890, but the level of prices has fallen since 1920 thus augmenting the importance of the increase in expenditure since that date. Also the population of the country increased during these years, thus in part accounting for this increase in expenditure. The population increase was, however, less than 100 per cent.

As the table indicates, the percentage of children of school age enrolled in school has increased considerably during this period. In 1890, less than 70 per cent were enrolled, and in 1924 more than 80 per cent. The fractional increase in the

[1] Department of Interior, *Bureau of Education Bulletin*, 1926, No. 23, p. 350.

Does this include bldgs & interest

percentage figures was one-sixth, or $16\frac{2}{3}$ per cent. But not only was there an increase in the percentage of enrollment during these years, there was also an increase in the average daily attendance of those enrolled. This increase was in excess of 50 per cent. Further, as the table shows, the average expenditure per pupil in attendance increased markedly, too. Almost six times as much per pupil was expended in 1924 as in 1890. Another significant feature in relation to the expenditure for schools is shown in the third column in the table; namely, the percentage of the total number of pupils that are in high school. In 1890, only 1.6 per cent of the total number enrolled in the elementary schools were in high school, but in 1924 the percentage so enrolled was 14. For 1920, the corresponding percentage was 10.2, and for 1910, 5.1. It is also interesting to note that in 1894–1895 there were 19 states that did not have compulsory school attendance laws, but in 1920 not a single state was without such a law.

Comparative statistics in regard to expenditures for state and municipal colleges, universities, and professional schools would show even larger proportional increases during the period of time under review. In Ohio, for example, the population increased by 52 per cent from 1900 to 1925; grade school enrollment by 36 per cent; high school enrollment by 286 per cent; and college and university enrollment by 460 per cent. These data for college enrollment include the enrollment in privately supported institutions, but they indicate the proportional increase in attendance at publicly supported institutions.

To an ever increasing degree not only elementary schools, but high schools, and colleges are being patronized by the young people of the nation. Social conventions are more and more prescribing the high school diploma, and the college diploma as a test of social fitness. Education, by which is meant school attendance and graduation, which has long been part of the general social ideal of Americans, is fast becoming a practical reality for an ever increasing portion of the population. Our economic efficiency makes it possible for the community to devote to this purpose not only the labor service of adults that

is expended in teaching, in building schoolhouses, and preparing the materials for such construction, but also the labor time of the children who attend school and are, say, over twelve years of age. Under rigorous economic conditions this would be impossible. But the portion of our total economic energy that we devote to education is not large. On the basis of the data of expenditures used above, it appears that only about 4 per cent of the total economic energy of the people of the United States, not counting the persons enrolled in schools, is devoted to this purpose.

Non-educational State Expenditures. — As noted above the expenditures, of all of the state governments taken together in 1925, for schools amounted to 38.2 of the total budgets. Library expenditure was 0.2 per cent of the total, making the combined budget for education 38.4. The next largest item in the combined budgets of the states was charities, hospitals, and corrections. This accounted for over 16 per cent of the total expense. Highways came next, representing almost 14 per cent of the total. Then came the expense for the general government, 8 per cent; protection to persons and property, 5.4; agriculture, 4.5; and other minor items.

Non-educational City Expenditures. — The largest item in the budgets of cities over 30,000 population in 1924, following education, which represented 39.2 per cent (38.0 for schools and 1.2 for libraries), was protection to persons and property, which represented almost 20 per cent of the total. Health and sanitation came next, 10 per cent; highways, 8.6 per cent; general government, 8.5 per cent; charities, hospitals and corrections almost 6 per cent; recreation, 3.2; and miscellaneous, 4.7 per cent.

Public Service Enterprises. — Many of the cities engage in what are called public service enterprises, of which water supply systems are the most important. Such industries brought into the city treasuries over 127 million dollars in 1924, but the total payments in respect to the services came to 170 million dollars. Only 65 millions of this was expense, however, the remainder being outlays for equipment and installations. The

sums for outlays were largely secured by borrowing. Perhaps during their lifetime such industries will be self-supporting. These items in city budgets were not included in the percentage computations of expenditures considered above.

It should also be noted that expenditures for schools, highways, etc., include amounts spent in constructing buildings, building roads, and making other permanent improvements. Such expenditures may properly be considered as outlays, and should be considered apart from current expenses such as salaries of officials. More accurately, the expenditure for a school building should be considered as spread over the years during which the building will be used. But, for the year in which it is built it is, of course, an expenditure. Further, since permanent improvements are being made year by year by the larger governing units, the inclusion of the total outlays in the yearly budgets does not give an untrue picture of the expenditures for single years.

The Justification of Public Expenditures. — Many very foolish ideas have been expressed in respect to expenditures by governments. Some men seem to regard public expenditures as not involving a cost to the nation as a whole. Since certain persons pay in money and the government then pays out the money to other persons, it is argued that there is no burden upon the nation as a whole. This line of reasoning overlooks the obvious fact that government expenditures result in the direction of economic activity. If labor and materials are used to build fortifications, then clearly this same labor and materials cannot be used in the production of other things. Public expenditures can be justified only by showing that the labor and materials used render service to the entire society. More accurately they can be justified only if the service rendered, as the result of the economic effort expended, is greater than would have been the case if the economic resources in question had been devoted to other ends.

During periods of unemployment, however, as stated in Chapter XXXII, somewhat different conclusions apply. Then the issue may be not between two methods of utilizing labor

and materials — one public and one private, but instead, so far as labor is concerned, whether men shall work at government account or be unemployed. Lines of government work are permissible at such a time that could not normally be justified.

PROBLEMS AND EXERCISES

148. "Every fourteen persons, sixteen years of age or older and gainfully employed, carry a public official on their backs." *The Hartford Courant*, 1927.

(*a*) What is meant by this statement? What is implied so far as return for this "carrying" is concerned?

(*b*) Construct similar statements substituting automobile workers for public officials. Compare the two statements.

149. How can you account for the great amount of government enterprise abroad as compared with the amount in the United States?

150. If government expenditures increase during the next decade, should you expect the increase to come more largely in national or in state and local expenditures? Why?

151. Account for the increase in school attendance. List several factors that account for your being in school. Were these equally applicable 50 years ago? Discuss.

152. General Grant argues in his *Memoirs* that seacoast defenses should be built. Even if they are never needed, he says, nothing will be lost since the money will be spent at home. Analyze.

CHAPTER XLVIII

PUBLIC REVENUE: TAXATION, GENERAL CONSIDERATIONS

Source of Revenue. — Public revenue is derived from several different sources: taxes, fees, assessments, loans, receipts from public enterprises, gifts, and, in the case of certain government units, from subventions or grants from other units. Taxes are by far the most important source of revenue. By a tax is meant strictly speaking a compulsory payment for general government purposes. A fee is a semi-compulsory payment for a particular service to some person. Thus the charge for recording a mortgage, for issuing a marriage license, or for admitting a student at a state university is a fee. It is only semi-compulsory, in that the person paying it need not ask that the service be performed. But it is in part compulsory in most cases, because only thus may a mortgage on real estate, for example, or a marriage be legalized. An assessment is a compulsory payment for a special purpose, as in the case of a levy against landowners to secure part of the funds with which to pay for the paving of a street. The other terms are self-explanatory. The last-named one is of increasing importance in the budgets of state governments due to grants from the national government in respect to highway construction and education. In 1925, 9.7 per cent of the total revenue of the state governments was from this source.

The distinction between taxes, fees, and assessments that is noted above is not followed in the census classification of public revenue. Receipts from the two last named are included under the term "special taxes." And in the popular discussions of these matters, fees, especially, are often spoken of as taxes.

Kinds of Taxes. — The number of kinds of taxes is legion. Among the taxes that are now used in the various states or by

the nation, the following may be mentioned: a per capita or poll tax, taxes upon property, upon the incomes of individuals and of business firms, upon inheritances, upon the sales of certain manufactured products, as tobacco, playing cards, medicinal liquor, and automobiles, sales of theater tickets, and also upon certain specified goods when they are imported into the nation.

Taxes are commonly classified into direct and indirect taxes. The conventional distinction between the two is that indirect taxes are shifted to the purchasers of the articles taxed, while direct taxes are those that are presumably borne by the persons who pay them in the first instance. The stamp tax levied by the national government upon playing cards and tobacco is an indirect tax. The presumption is that the tax payments are added into the prices of the products by the manufacturers. A tax on a farm is regarded as a direct tax, and, as well, a tax on city dwelling houses. The tendency is, however, for a tax on houses to be shifted to tenants, as noted in an earlier chapter. But the common presumption is that that is not done, so the house tax is regarded as a direct tax. Also, conditions might be such that a sales tax, such as is now levied on automobiles by the United States Government, would not really be added into the price of the article that is taxed. But since the presumption is that that is done, such a tax is called an indirect tax. Certain kinds of indirect taxes are also called excise taxes. Any stamp tax such as the one on tobacco or playing cards is an excise tax. Customs duties are indirect taxes, but are not called excise taxes.

Criteria as to Tax Apportionment. — One of the most important questions in regard to taxation has to do with the basis upon which taxes should be assessed upon the various individuals in the community. Three different bases will be considered. First, it may be held that persons should pay taxes according to the benefit which they receive from the government. Second, they might be asked to pay according to the cost of the government of furnishing them the government services which they individually use. And, third, persons might be asked to pay taxes according to their relative abilities to do so.

The apportionment of taxes according to the benefit received, or according to the cost incurred was strongly advocated several years ago, but recently it has come to be almost universally agreed that taxes should be apportioned among the inhabitants of a community in proportion to their respective abilities to pay taxes. The benefit and the cost theories are posited upon an individualistic view of society, while the ability theory if broadly interpreted is posited upon an organic view of society.

The organic view of society has general acceptance now. Persons no longer think of a society as being made up of a group of individuals that voluntarily live together as a community. Rather, the view is that persons are born into a community and are a vital part of it, and it of them. In using the term "organic," there is no suggestion that the society is organic in a physical sense but only that it is organic in a functional sense. In a human society, as St. Paul said to the Church at Ephesus, "we are members one of another." In other words, a society, a state, a nation is an organic whole; it is a coöperative enterprise. That being true, it becomes the duty of each person to contribute to the welfare of the general community. This largely takes the form in our society of the various individuals' producing on private account goods and services that are socially desirable. Through the principle of specialization, various individuals thus mutually coöperate to help the nation make its living. In the field of taxation, the application of this principle of mutual coöperation calls for the payment of taxes by individuals according to their respective abilities.

Not only is the principle of payment of taxes according to ability socially defensible as just noted, but in most cases it is impossible to determine accurately the value of the benefits received or the cost incurred in respect to the various persons concerned. The value to any one citizen of the maintenance of a state university could not well be determined, nor could it be determined how much it costs a city to provide police protection for a particular individual. In some branches of the public service, benefit and cost could be determined, roughly at least. The cost of protection against fire, for example,

might thus be apportioned although the cost of police protection to life and property could not be determined for various individuals. Generally speaking, it would be impossible to apportion government expense on either the benefit or the cost basis.

The Measure of Ability. — Assuming then that persons should pay taxes according to their ability, the question arises as to how ability is to be measured. The ability to pay taxes, obviously, rests on the possession of economic goods or, more properly, on the receipt of economic income. But how does ability vary among different persons? Does it vary, for example, in proportion to income? If one person has an income of $10,000 and another person an income of $1000, do their abilities to pay taxes vary as ten to one, or is there a greater variation in ability? Does the one who has an income of $10,000 have the ability to pay not merely ten times as much in taxes as the other but, say, twenty or thirty times as much? In other words, if tax rates are levied according to ability to pay, shall we have proportional tax rates or progressive tax rates? Consider the following table:

TABLE 8

PROPORTIONAL AND PROGRESSIVE TAX RATES

	Amount of Net Income	*Rate Per Cent*	*Tax*	*Net After Tax*	*Rate Per Cent*	*Tax*	*Net After Tax*
A	$ 1,000	2	$ 20	$ 980	0	$ 0	$ 1,000
B	5,000	2	100	4,900	5	250	4,750
C	10,000	2	200	9,800	10	1,000	9,000
D	100,000	2	2,000	98,000	30	30,000	70,000
E	1,000,000	2	20,000	980,000	50	500,000	500,000

In this table, there is indicated, first, the results which would follow from the application of a tax rate of 2 per cent upon each of these five incomes. The payments from such a tax are shown in the third column. They are in proportion to the incomes of the five persons. The next column shows the amount that would remain to each one of these five persons after paying the 2 per cent tax. A would have $980 left and E, $980,000.

These two sums are so different that the conclusion seems warranted that the 2 per cent tax does not take from them according to their respective abilities. But if a proportional rate does not conform to the ability criterion, what progressive rate shall be used? Would rates as given in the second part of the table result in tax payments according to ability? Is E as able to pay one-half of his income, as B is to pay 5 per cent of his? And should A be exempt in view of the ability of the other men to support the government? The answer to these questions is that no one can answer them with a high degree of accuracy. It is safe to say that the ability of different income receivers to pay taxes does not vary in proportion to their incomes. The rich man is better able to pay a certain rate than is a poor man. But no one can say just what rates would be in accordance with the relative ability of the two. Progressive rates are in line with the ability principle, but there are no scales on which relative ability can be accurately measured.

The ability theory must then be applied broadly because of the impossibility of accurately measuring ability. The rates that are applied should be determined in accordance with the general social interest. The poorer persons should not be entirely exempt from taxation. If this were done, their political power might result in taking so much from the rich that disastrous results might follow. Waste and extravagance in the use of public funds might result, and also the tax burden on the more well-to-do might impair private industry. The funds that should properly be devoted to private enterprise might be diverted to ill advised government projects, and the onerous taxes might lead to a curtailment of economic activity on the part of the richer persons. The ability theory must then be applied with caution. This is the way in which it is being done. Legislators impose tax rates in view of the situation confronting them. They have apparently not erred, so far, in America, in carrying the ability doctrine to undue lengths.

It may be argued that the above considerations amount to an abandonment of the ability theory and the substitution of what has been called a socio-political theory. This is true if

the ability theory is to be interpreted rigorously: there is no other recourse. The ability to pay, as already argued, cannot be accurately measured. The ability principle can be used only as a general working rule. As such it is sound and practical.

Aside from the question as to what rates are desirable at any one time, progressive rates are now well established as part of the tax systems of the leading industrial nations. Such rates are usually applied to income taxes only. Other taxes, in perhaps all countries, are proportional to ownership, or income, and others are regressive in principle. That is, the rate paid by the poor is higher than that paid by the rich. Thus the progressive rates on incomes may only amount to making the tax payments as a whole proportional to income. Indeed, many students argue in support of progressive rates on income in order that the regressive feature of taxes on certain forms of property and on consumption may be corrected. The regressive nature of much of our taxation will be noted in the following discussion. Perhaps the progressive rates in our national income tax, and in the income taxes that are found in a few of the states, do not go so far as to make the tax payments of the various persons who are subject to taxation, indirectly as well as directly, proportional to their respective incomes. Our tax rates, considering all of our taxes, may be regressive in spite of the progressive rates.

A century ago, the idea of progression in taxation was vigorously opposed. Learned men insisted that if a legislative body once departed from the rule of proportional rates it would be like a ship at sea without rudder or compass,[1] and the implication was that tax rates would then speedily become confiscatory. And as late as 1894, in an argument before the United States Supreme Court in the Income Tax case, one of the leading attorneys of the country protested against progressive rates as "communistic."[2] But such protests against progressive rates are no longer made.

[1] See J. R. McCulloch, *Principles of Economics*, 1825.

[2] Joseph H. Choate in argument in Pollack v. Farmer's Loan & Trust (1894), 157 U. S. 429.

It is well to note that the exemption of a certain amount of income results in a progressive rate of taxation, even if a proportional rate is levied; thus if all incomes up to and including $2000 are exempt, and if a rate of 2 per cent is imposed on the amount of income that exceeds $2000, the tax rate upon a person with an income of $4000 would be 1 per cent. He would pay 2 per cent tax on $2000. A person with an income of $8000 would pay 2 per cent on $6000 or a total of $120. This would be a rate of $1\frac{1}{2}$ per cent. The income in the second case is twice that of the first but the amount of tax is three times as much. Also, of course, one who possesses an income of $20,000 would pay taxes upon $18,000 which would amount to $360. This would represent $1\frac{4}{5}$ per cent of the total income. The tax rate that is paid, under such an arrangement, will thus gradually increase as income increases, but it will never reach the nominal rate, 2 per cent in this case.

Regressive Rates. — The opposite of progressive rates, in the matter of taxation, is regressive rates. That is, by regressive rates, as already indicated, is meant a condition in which the rate of taxation becomes less as the amount of income increases. An import duty on sugar amounts to a regressive rate of taxation. The sum paid in taxes by the poor when sugar is purchased necessarily represents a larger portion of income than is paid by the more well-to-do, when they purchase sugar. All indirect taxes tend to be regressive in rate. The general property tax also tends to be regressive. The farming class as a whole pay a much higher rate on the property that they own than do many groups in the cities. But the nominal rate is the same. This results because of the undervaluation of much of the city property.

The Shifting of Taxes. — As was mentioned above in the discussion of direct and indirect taxes, and also in the chapters on *price*, the incidence of a tax does not always correspond with its payment. That is, if two men are taxed one may be able to add the tax into the prices of the goods or services which he has to sell while the other may be unable to do this. The incidence of the first tax would thus be upon the consumers of

the goods or services in question, but in the other case, the incidence of the tax is upon the original taxpayer. This is a problem in pricing, as has already been frequently emphasized in the chapters to which reference has just been made. The analysis which was given earlier need not be repeated in full at this place, but the importance of the subject justifies a brief review of the matter and the use of some additional illustrations.

Primarily, the question of tax incidence turns upon the question of the effect which a given tax will have upon the supply of and demand for the goods and services involved. A tax cannot normally be expected to increase the demand for the products which are taxed, and hence if a tax is shifted through an augmentation in the price of the article involved, this must come about because the tax results in a reduction of the supply of the particular good or service. Thus the question always involved in the matter of tax incidence is as to whether the tax results in the supply of the good or service in question being lower than it otherwise would have been.

The analysis in regard to a tax upon land value as compared with the effect of a tax levied on the value of a house may be repeated. The house tax will increase the cost of supplying houses for the use of tenants and thus tend to check somewhat the building of houses. This will result in the supply of houses being less than it would have been if the tax had not been imposed, and hence landlords will be able to charge higher rates to tenants than they would have been able to charge if the tax had not been levied. In the case of a tax on land value, however, the tax payment by the landowner will not result in the withdrawal of any land from the market. The amount of land in use will thus be the same after such a tax is levied as it was before, and thus the supply of products from the land, or of services from the land, will not be reduced, and hence their prices will not be increased as a result of the tax.

As was emphasized in the discussion of the prices of goods produced by concerns that have large fixed plants, the imposition of a tax upon units of output will normally be borne by the owners of the industries in question. Such concerns could

increase the price of their products only by reducing the supply of them. But to reduce the supply would mean that the average cost of production would be increased, since the total overhead would be spent on a fewer number of units than had formerly been the case. Hence, under such conditions, a business concern might find that its net loss would be less by bearing the tax, than by shifting it to the consumers of the product.

A tax upon monopoly profits, as was also discussed earlier, will tend to be borne by the monopolist. Since the monopolist has presumably already adjusted his output so as to get the largest net profit, the reduction of such profit by, say, 10 per cent will leave to him a larger amount of money than he would have left if 10 per cent were taken of any smaller sum. Thus the monopolist would find it to his advantage to bear a tax upon his profits rather than attempt, through reduction in supply, to increase the price of the goods which he is selling. But if a tax is levied upon the units of output of a monopolist, it might be to his advantage to reduce the output and thus increase the price. This depends, however, upon the situation of the particular monopolist. If he has a large fixed expense, as in the case noted in the preceding paragraph, a reduction in output would tend to increase his average cost and would thus not increase his net profits.

A uniform tax upon all lines of business would mean that marginal producers would feel the burden of the tax and would thus tend to be forced out of business earlier than would otherwise be the case. Hence a uniform business tax will tend to be shifted. At the present time, the national government imposes a tax of 12 per cent upon the income of all corporations. This tax may thus be looked upon as one of the ordinary expenses of conducting a business under the corporate form of organization. It has undoubtedly come to partake of the nature of bills for raw materials or labor. Thus we should expect that supply in the various lines of business would have been adjusted somewhat in view of this tax, and hence that it is borne by the persons who consume the products of corporations.

Is an Income Tax Shiftable? — A progressive income tax is commonly said by authorities on taxation to be non-shiftable. The argument is that since such taxes have presumably not been high enough to drive persons out of economic activity, they have not resulted in taxable incomes being higher than they would have been if the taxes had not been levied. But if such taxes were levied upon incomes derived from business enterprise or from personal service, in some one industry, as, for example, the iron and steel business, they would surely be shifted. Persons would forsake the one field, and returns in it would rise sufficiently to cover the tax. But the general argument is that so long as the tax is applied throughout the economic system, it is not shifted.

The conclusion just reviewed is perhaps sound, so far as the present income taxes are concerned. An argument may be made, however, that a heavy tax upon personal incomes would be shifted, if in force for a long time. Under our competitive system, men are largely placed at the jobs they hold by means of economic rewards. Let us assume that one man is given $5000 per year to get him away from a $4000 job; another $7500 to get him away from one that pays him only $5000; another $10,000 to induce him to do a certain task rather than one that would pay him $7500; and so on for the other salary ranges above this. If the persons paying these salaries are good bargainers — if they spend their money carefully — then these salaries are the minima that must be paid in the different cases. If that is true, then the imposition of a progressive tax on incomes would disturb this placement. If $4000 in income is not taxed but if a $5000 income receiver must pay $500 in taxes; a $7500 one $900 in taxes; and a $10,000 one $1400 in taxes, then on the assumptions made, these salaries will not secure the placement that they would without the tax. If a salary of $5000 is necessary in order to get men to take job *X* rather than job *Y* at $4000, then job *X* can't be filled at $4500 net. Under the assumptions laid down, these salaries would have to be adjusted in view of the taxes. The taxes would be shifted. Perhaps persons already placed would not leave the jobs they

occupy, but later ones would not be attracted until salaries were increased.

But it may be argued that the preceding presentation of the placement process is not sound. It may be said that $5000 is not offered to get men away from $4000 jobs; but that the higher salary is paid because two or more employers with a position to fill bid against each other. One must pay $5000 because the others will pay this much. The employee in question would take the one kind of job as quickly as the other, it may be argued. Indeed, assuming that the more highly paid job offers more opportunity for self-expression than does the other, it is reasonable to believe that the usual person who is qualified to do the work in question would prefer the one task if the pay were only equal to, or even lower than, the pay in the other. Hence, this argument would conclude, $5000 in salary is not necessary in order to get men away from $4000 positions, but only in order to get them to fill one $5000 position rather than another. If this is true, the reduction of net returns in all such positions will not disturb placement.

Each of these two analyses is perhaps sound in part, but the latter is perhaps more universally true. If it is, if competition is among positions of a given grade rather than among positions of different grades, then a personal income tax will not be shifted, save in the exceptional cases in which competition prevails among jobs of different grades.

Further, in so far as the first of these two assumptions is sound, there are two factors in the situation that tend to lessen its importance, and thus prevent the shifting of an income tax. First, it may be noted that salaries have prestige value to some extent. The receipt of a salary of $15,000 on which there is a tax of $1000 is perhaps preferred by many persons to a salary of $14,000. In so far as that is true, the tax of $1000 will not disturb placement. Second, the differentiation among salary payments tends to increase as salaries grow larger. For the same reasons that small prices are set in "even money" rather than in "odd figures" — 15 cents and 25 cents, for example, rather than 16 cents or 24 cents — salary rates are in round numbers

and differ by $500, $1000, or $5000, depending on the size of the payment. In so far as this custom prevails, tax payments that are less than the excess of the salary over the next lower salary will not disturb placement, even when competition does run between positions of higher and lower grades.

The Excess Profits Tax. — During the World War, a special tax was levied upon the large profits of industrial enterprises. This was known as the excess profits tax. No firm was subject to the tax unless it earned more than $3000 above 8 per cent on its capital. The rates were progressive above this amount. Shortly after the war, the tax became the subject of severe criticism. It was argued that the high prices of commodities which prevailed at that time were due to the excess profits tax. The price analysis which has been given above suggests that this conclusion was unwarranted. Only those were subject to the excess profits tax who had large profits. They were not marginal firms. It is very unlikely that any of these firms were driven out of business or led to curtail their output because of the necessity of paying part of their profits to the government in the form of taxes. Indeed, in many cases the tax operated to induce firms to undertake larger production.

The tax resulted in an increase in production in many cases because any expense that was incurred led to a reduction in net profits and thus to a reduction in the tax payment. Hence firms could make outlays for new products and incur additional expense even if they believed such expense did not afford a reasonable profit on the amount thus expended. If, for example, a firm's business was calculated to result in profits of $200,000, and if the managers appreciated that in case such profits were earned, it would be necessary to pay, say, half of this amount, or $100,000, to the government, the entire amount could be spent profitably by the concern, thus wiping out excess profits and any tax payment thereon, so long as the value received was in excess of $100,000. This suggests that the tax may have resulted in many cases in the wasteful expenditure of money. Incidentally, too, in many cases it resulted in an increase in wages paid to employees, and, to

return to the above point, such expenditures undoubtedly resulted, in some cases at least, in an increase in output above that which would otherwise have been forthcoming.

There is one way, however, in which the excess profits tax may have operated to cause the prices of commodities to be higher than they otherwise would have been. Namely, such taxes, by taking funds from industrial enterprises, may have prevented extensions of plant that would otherwise have been made, which would have augmented the product and lowered prices. But speaking generally, the analysis of the price-making factors involved led to the conclusion that the excess profits tax was not a causal factor in the high prices which prevailed during the time it was in operation. A study of the history of prices during this period corroborates this analysis. The tax rate on profits was altered from time to time during the years 1917–1921 and the level of prices in no way shows any conformity to such changes in the tax law.[1]

The Gasoline Tax. — One very interesting problem in this connection centers around the tax on gasoline which has come to prevail in practically all of our states. The prevailing opinion, is that this tax is borne by the users of gasoline. Perhaps this is true, but under certain conditions the tax would be paid by the gasoline companies. If, for example, the gasoline business were conducted as an integral part of the production of crude oil, that is, if the companies that produce oil also refined gasoline and sold it to the public, it would appear that the gasoline tax, for a period of several years anyway, would be paid by these producing companies. The only way that such companies could escape the tax would be by making the supply of gasoline lower than it would otherwise have been and thus making the price higher than it would otherwise have been. But considering the nature of the oil business and the large investment involved in oil wells, pipe lines and refineries, it would not seem that the companies would find it economically profitable to reduce the output below that which their facilities made pos-

[1] For a detailed study of this situation see David Friday, *Profits, Wages, and Prices*, 1920, Chapter XII.

sible. Thus the tax would not result in any withholding of the supply and hence the price could not be higher than it otherwise would have been.

If, however, the business of refining and marketing gasoline is separate and distinct from that of producing oil — if the gasoline companies buy the oil as raw material — it is reasonable to believe that gasoline producers would restrict their purchases of oil for the refining of gasoline to a point that would make it possible for them to sell gasoline at a sufficient price to cover their total cost including the tax which they must pay to the government. As a matter of fact, the business of refining gasoline is largely in the hands of independent companies and apparently they have operated as suggested in respect to the tax. Thus the price of gasoline is higher than it would have been if these taxes had not been levied.

The question may arise as to why the refining companies would not have raised the price to the amount which now prevails even if the tax had not been levied, and thus have had the extra profit that could have been derived at the higher price. An answer to this is that the competitive conditions that prevail among refineries would tend to make this impossible. This competition tends to keep price somewhere near cost. Thus it is only as the refineries throughout the entire marketing area find it necessary to raise prices in order to cover the new additional cost that the increase in price is brought about.

Tariff Duties. — The incidence of tariff duties is also interesting in this connection. Tariff duties force foreign producers to increase the prices of their products above the prices that would otherwise prevail, and thus permit domestic producers similarly to increase the prices of corresponding articles. Thus the tariff raises the prices not only of the goods that are imported but also of the goods that are produced here in competition with the foreign competitors. Indeed, this is clearly the object of the tariff. If it does not raise prices, the object of its advocates is not realized. Further, in this connection, it is interesting to note that the addition to prices as a result of a tariff duty may be greatly in excess of the duty. If, for example, a tariff of one-

half cent per yard is laid upon cloth that is imported, it is easily possible that consumers may be charged fifteen or twenty-five cents more per yard as a result of this slight tariff impost. The analysis is that the increase of the charge to the importer of one-half cent per yard may result in an increase of his price by one cent, an increase in the price of the next person in the chain of middlemen by five cents, then an increase of ten cents, and finally an increase to the consumer of twenty-five cents per yard.[1] This suggestion of the possibility of a given tariff duty increasing prices by considerably more than the amount of the tariff duty can also be applied to the general field of taxation. The prices of products may be augmented by considerably more than the amount of the tax.

Not All Taxes Are Shifted. — The above analysis points inescapably to the conclusion that while some taxes may be shifted, not all taxes may be shifted. Many business men state from time to time when discussing tax problems that the burden of all taxation rests finally upon the ultimate consumer. This, to repeat, is erroneous. Indeed, if this were true, it would seem not to be to any person's interest to oppose the levying of taxes upon the line of work in which he is engaged. The fact that many of the persons who insist that all taxes are shifted into the prices of products, do so at the same time that they are protesting against the payment of heavy taxes, would seem to indicate that they are not altogether sincere in their analysis, for if their analysis be true they are not any worse off because of the tax nor would they be any better off if the tax should be removed from them.

Inheritance Taxation. — The modern industrial nations have greatly developed the use of inheritance taxes during the past several decades. These taxes conform to the principle of payment according to ability. They tend not to be at all onerous, since the tax is deducted from the inheritance, which may in almost all cases be considered to be a gift. Further, inheritance taxes tend to reduce the amount of wealth that individuals would

[1] H. C. Emery, "The Tariff and the Ultimate Consumer," *American Economic Review*, March, 1915, Vol. 5, p. 534.

otherwise have, and in the case of large fortunes such reductions are generally assumed to be socially desirable.

It used to be argued that inheritance taxes reduce the amount of capital. This argument is but little used now. Clearly if one is inheriting part ownership in a steel mill the taking of a share of this by the government does not result in the destruction of the mill. The sale of securities in order to pay the tax leaves the mill intact. There is merely a shift in ownership, which may or may not lead to more efficient management. Further, capital accumulation is perhaps but little checked as a result of an inheritance tax. The inheritor cannot save as much of the estate as he otherwise could, but if such a tax is a substitute for other taxes, other taxpayers will have more money to save than otherwise. It is also to be noted that the need for additional savings is less now than was true several decades ago. The social interest, even at the expense of some capital accumulation, may easily be better served by taking liberally from the large estates, than if the family holdings are not disturbed.

It is also argued at times that if men cannot bequeath their property to their heirs, they will not apply themselves so zealously to business affairs. This is a false argument in the case of perhaps almost all business men. The motives that spur them on are, for the most part, not that they or their children may have money, beyond a moderate amount, but rather that they may succeed in the game of making money. Their interest is in crowding out competitors, in building large plants, in selling a large volume of produce, but not in consuming goods nor in providing the means for their children to do so. They may try artfully to avoid the inheritance tax, but again this is part of the acquisitive game. Andrew Carnegie, one of our richest self-made men, was a warm advocate of heavy inheritance taxation. He did not regard such taxes as a curb on industry.

PROBLEMS AND EXERCISES

153. Is the charge for automobile registration a fee or a tax? Why?

154. Give an illustration showing the impossibility of accurately measuring the relative abilities of two persons to pay taxes.

155. Suppose a case of two property owners each subject to a general property tax of 2.4 per cent and show a condition which would mean that the rate of tax actually paid is regressive.

156. Give an original illustration to show the effect of a tax upon the unit of product of a manufacturing plant.

157. Under what conditions would a tax on incomes be shifted? Under what conditions would it not be shifted?

158. Construct a diagram showing the supply and demand in the case of a monopolized good. Prove that a tax upon the unit of output would alter the price. Prove by means of the diagram that a tax upon the profits of this concern would not alter the price of the product.

159. "I know from my own experience that the excess profits tax is added into the price of our product." A Manufacturer. (*a*) Give an argument in support of this statement. (*b*) Argue that the price might have been increased even if the tax had not been levied.

160. Assume a situation in which the gasoline tax would be paid by the gasoline companies and not added into the price of gasoline.

161. "Regardless of where the tax is levied it is finally paid by the consumer." Is this valid? Discuss using illustrations.

CHAPTER XLIX

STATE AND LOCAL REVENUE

State Revenue. — According to the report of the United States census,[1] the forty-eight states received over 24 per cent of their revenue in 1925 from the general property tax, and over 34 per cent from business and non-business license fees. This, in most states, includes special taxes upon corporations and also receipts from the gasoline tax which has recently become an important part of the revenue of the state governments' receipts in many states. Almost 16 per cent of the revenue came from what are called special taxes. This includes receipts from income taxes in thirteen states and from inheritance taxes in forty-five states. Fees, such as are charged for the recording of mortgages, are also included in this category. Ten per cent of the states' revenue came from subventions and grants, donations and pension assessments. A considerable portion of this consists of grants from the United States Government in respect to education and construction of roads. Special assessments and special charges for outlays accounted for a little over 2 per cent of the total receipts. The earnings of general departments represented 8 per cent of the total receipts. These include receipts from certain fees and from rents, sales and other similar sources. These data, it must be noted, refer only to the revenue that is used by the state governing units. It has no reference whatever to the receipts of revenue by the various local units.

The Revenue of Cities. — The census tabulates the revenue of one hundred and forty-six cities with population of thirty thousand or more as follows, for 1924:[2]

[1] Financial Statistics of States.

[2] Financial Statistics of Cities.

	Per Cent
General property tax	66.1
Other taxes	5.7
Special assessments	5.9
Subventions and grants, donations, and pension assessments	5.3
Earnings from business enterprises	10.3
Other revenue	6.8

The significant item in these data is the figure representing the proportion of revenue that comes from the general property tax. This was the source of two-thirds of the revenue in these cities.

The General Property Tax. — As is indicated in the above data, the general property tax is a very important source of revenue among our state and local governments. A few of the states receive but very little or no income from the general property tax for the assistance of the state governments. But as the table shows, the general property tax is the chief source of revenue for the cities. In the case of the other local units, the small cities and the counties and townships, the general property tax constitutes almost the sole source of revenue in most of the states.

The general property tax grew out of the taxes that were in an early day imposed upon property which consisted almost solely of land and houses. As other forms of property grew in importance, the property tax was extended to them until it came to be assessed against all property and thus became known as the "general property tax." The tax law of Ohio is typical of the laws of most of the other American states. It provides for the taxation of all forms of property or property rights: land, buildings, machinery, live stock, household furniture, including rugs, pictures, books, and table equipment, jewelry, bonds, stocks of corporations chartered outside of Ohio, bills receivable, and money in the bank or in one's purse. These are all taxable under the Ohio law at full cash value. This is not merely the statutory law but is embodied in the constitu-

tion. According to Article XII, "Laws shall be passed, taxing by a uniform rule, moneys, credits, investments in bonds, stocks, joint stock receipts, or otherwise and also all real and personal property, according to its real value in money."

The general property tax has been vigorously condemned by all careful students of the subject. An eminent authority on taxation says, "The general property tax is beyond all doubt one of the worst taxes known in the civilized world. . . . It is the cause of such crying injustice that its alteration or its abolition must become the battlecry of every statesman and reformer."[1] But with a persistency that is remarkable the method is retained. In many states, however, the general property tax has been greatly modified and supplemented by other taxes. For example, as will be noted later, some thirteen of our states now have an income tax as part of their tax systems.

Proportional Rates on Property. — At best, the general property tax results in the levying of proportional tax rates upon all property. It was developed in the preceding chapter that the canons of justice in taxation call for progressive tax rates upon income. The general property tax is not in accord with this principle for two reasons. In the first place, property ownership does not indicate income. Many persons have a large personal income without holding any property at all. According to the federal income tax returns for 1921, almost 60 per cent of the total income of individuals reported for taxation resulted from the rendering of personal service. In other words, approximately 60 per cent of the income thus reported did not result from the ownership of property. Hence, as income is the criterion of ability to pay taxes, the general property tax stands condemned as inadequate on this score.

In the second place, incomes are not only received apart from ownership of property but various forms of property differ greatly in the rate of income which they return to their owners. Consider three kinds of property, namely: (1) a manufacturer's plant, worth $5000, (2) $5000 of 5 per cent bonds, and (3) $5,000 worth of household furniture, books and pictures. Clearly

[1] E. R. A. Seligman, *Essays on Taxation*, 9th ed., p. 62.

the rate of income from the three properties may be markedly different. The manufacturing plant may earn 15 per cent net income, the bond 5 per cent, and the household goods nothing at all in the form of money income. It would seem clear that if these three properties are the sole possessions of three different persons their abilities to pay taxes would be markedly different. Thus for these two reasons the ownership of property does not indicate ability to pay taxes. Further, of course, even if property ownership should represent ability to pay taxes, the tax would fall short of being a good tax because the rate is proportional to property ownership and not graduated progressively so as to result in the more well-to-do persons paying higher rates of taxation than the persons at the bottom of the income scale.

Tax Evasion under the General Property Tax. — The preceding analysis has rested on the assumption that the general property tax operates as is intended. This, however, is far short of the actual situation. The tax evasion under the general property tax is so marked that in its practical operation the tax renders gross injustice as compared to what it would if it could be administered as its sponsors expect it to be.

First, there is great evasion of taxation by owners of what is called intangible personal property. By intangible property is meant stocks, bonds, mortgages, bills receivable, and money. It is very easy for the owners of such property rights to evade the law requiring that such claims to wealth shall be taxed. Tax officials have no way of knowing how many stocks and bonds one may have locked up in a bank box. Further, the fact that most of such claims escape taxation brings it about that the rates of income which bonds and other securities return to the owners are adjusted to a tax escape basis. Bonds sell in Ohio, for example, at a price that will permit the owner to receive from the company about 5 per cent on his investment. The rate of taxation in the state is approximately 2.5 per cent. Hence under the state law, a bond that is taxed at its market value would yield 5 per cent to the owner and he would be called upon to pay in taxes an amount equal to one-half of this in-

come. The tax on bonds, in other words, amounts to a rate of approximately 50 per cent of the income. If they were all reported for taxation, rates of income would be adjusted in view of the tax, but since only a few of them are taxed this adjustment is not made, and the rate is unconscionably heavy on those who do pay the tax that the law specifies. This heavy rate of tax payment further encourages the establishment of a code of conduct to the effect that it is not improper to practice such tax evasion. This reduces still more the listing of such securities, and increases the injustice to the persons who do make honest reports of their "intangibles."

According to the state reports for the year 1922, the amount of intangibles assessed in Ohio amounted to less than 5 per cent of the total assessment of all property and to less than 50 per cent of the total amount of personal property returned for taxation. In the state of Kansas for the same year, the corresponding figures are 7 per cent and 32.5 per cent. Certainly it cannot be questioned that the total value of stocks, bonds, and other similar evidences of ownership in Ohio is greatly in excess of 5 per cent, and in Kansas in excess of 7 per cent of the total personal property and real estate owned in these states. No one knows what portion of such intangible property is returned for taxation, but there is no question that only a very small portion of it is listed.

Double Taxation. — The taxation of intangible property is often condemned on the score that it amounts to double taxation. The point is that since so-called intangibles merely represent claims to goods, the taxation both of the goods and of the claims to the goods amounts to double taxation. But double taxation is not in itself bad. If, for example, all intangible property were taxed and at the same time all other rights to property were taxed, in addition to the physical property itself, double taxation would result, but this would not involve any inequality because all property would be taxed twice. In the case of a farm that was not mortgaged, this would involve reporting the farm for taxation at its value, say, $10,000, and then also reporting for taxation the farmer's right to the farm,

$10,000 more. An adjoining farm worth the same amount upon which there was a mortgage of $5000 would be taxed at $10,000 to the owner of the farm, and $5000 to the owner for his equity above the mortgage, and then the holder of the mortgage would be taxed for his claim of $5000 against the farm. The total assessment against each farm would be $20,000. The persons involved in these two cases would be treated equitably. No one could complain of the double taxation.

Similarly, as between two manufacturing plants, each worth $100,000, one of which is owned by a corporation and the other by a private individual, each would be reported for taxation at $100,000, and in addition, in the case of the one that is owned by the corporation, the corporate securities — stocks and bonds — would be assessed at $100,000 to the owners thereof, and in the case of the other one, the owner's right to the plant would be assessed at $100,000. Since all property would thus be doubly assessed, no injustice would result. It would be absurd to do this, as the same relative results could be produced by merely taxing once the wealth involved, but as these illustrations show, double taxation is not *per se* inequitable.

But what happens under the general property tax is that only property that is held by corporations, or that is mortgaged or otherwise has paper claims against it, is subject to double taxation. Thus it becomes inequitable. This point is appreciated somewhat in general property tax states, as is evidenced by the provision in the Ohio law that stocks of corporations that are located in the state are not to be taxed. This is clearly in violation of the terms of the constitution quoted above, but it indicates some appreciation of the fact that stocks are of the nature of milk tickets. But the exemption of the stock of corporations organized within the state makes it perhaps even more inequitable to tax the stock of non-state corporations.

As was emphasized above, the fact that but relatively few stocks, bonds and mortgages are returned for taxation leads to grave injustice in the case of persons who do so report them. If they were universally reported, income rates upon stocks, bonds, mortgages, etc., would be adjusted in view of this fact. But

they are not reported for taxation, and if experience is any guide at all, they never will be.

Tax Evasion from Underassessment. — The general property tax also leads to marked inequality as the result of underassessment of property. This comes in part from the method of assessment. Each locality has its own assessor and taxes must be paid to the county and state governments on the basis of the total amount of property that is assessed. With a given state tax rate, the people of township "*X*," for example, will have to contribute only half as much to the state treasury if \$500,000 of property is reported for taxation as would be the case if \$1,000,000 should be reported. So far as the township taxes are concerned, underassessment does not make any difference as the rates must necessarily be higher if the property is underassessed. The gains come in being able to escape from state and county taxation as a result of undervaluation. The prevailing practice of underassessment in respect to the general property is almost ludicrous. In the state of Iowa, for example, not many years ago, a rule was established that property should be assessed at 25 per cent of its true value. There are perhaps few states in which property is recorded at more than 50 per cent of its value, despite the strong words of statutes and constitutions to the contrary, and also despite the formal oath which tax assessors must take and which property owners must take when they report their property for taxation. Underassessment is not in itself an evil if the same proportion of true value is used in the case of all persons. But the fact that underassessment is the prevailing rule in America, under the general property tax, indicates the breakdown of administrative machinery in respect to the tax.

Certain forms of property are clearly underassessed in most cases. The assessed valuation of household goods represents but a very small fraction of the total value of such goods. An investigation in Connecticut a few years ago revealed the fact that the amount of jewelry returned for taxation by all of the people of the state did not amount to the yearly sales of one of the jewelry firms in New Haven. The stocks of merchants, also,

are usually grossly underassessed. Such stocks do not measure the relative ability of merchants to pay taxes as can be seen by contemplating the difference in the rate of turnover in, say, 5 and 10 cent stores and furniture stores. But, however this may be, assessors are required by law to report such property at full value. They seldom list more than a small fractional part of it.

Since automobiles are subject to license registration, it would seem that one might expect that all automobiles would be reported for taxation. An investigation in Ohio a few years ago showed that on the contrary even this form of personal property escapes taxation to a remarkable degree. In short, no state has been able under the general property tax to secure anything like a full assessment of the property of the state.

The Taxation of Real Estate. — The significant item in the general property tax is real estate. Indeed, about four-fifths of the total property assessment for purposes of taxation consists of real estate. There may be great inequality in the taxation of real estate from one county to another and thus inequality so far as payments to the state are concerned, but it is impossible that real estate owners can escape taxation under the general property tax.

Reform of the General Property Tax. — Most of the careful students of the problem of state and local taxation recommend that the general property tax be reformed by abandoning entirely all attempts to tax intangibles, and also abandoning all attempts to tax tangible personal property. No one, however, advocates abandoning the tax on real estate. This is a very successful tax. It is easily administered, and further, the ownership of real estate indicates roughly ability to pay taxes. Further, as the analysis in preceding chapters has indicated, when a tax is imposed on land, the state becomes a part owner therein and when the land is sold, the succeeding buyer buys subject to the land tax. That is, the new owner really buys the equity in the land above the portion which the state owns as a result of the tax. Hence, to lower a tax on land amounts to the making of a gift to the person owning land at the time the reduction is made.

As will be noted in the chapter dealing with land rent, many

persons insist that the increase in land value should accrue to the state through an imposition of special taxes upon such increases in land value. The usual program proposed is that the tax should be so adjusted that there will be no confiscation of land values. But as will be shown in the chapter referred to, very liberal exemptions would have to be provided in order to prevent a scheme for the levy of special taxes upon an increase in land value from confiscating something of the present value of land. However desirable some such scheme as that may be, it should be noted that the usual tax upon real estate accomplishes something of the same purpose that would be accomplished by a special tax upon the increase in land value. For as land values increase, and as the assessed valuation is raised, this means that a portion of the increase in land value is taken by the state.

State Income Taxation. — One significant modification of the general property tax has been the introduction of income taxes in several of the states. Wisconsin made such a provision in 1911. Since that time twelve other states have provided for income taxes. One of the significant features of state income taxation is the administration of such taxes by the state governments, rather than by the various localities as in the case of the general property tax. State administration can normally be expected to secure better results than can the administration by localities. The officials in charge are likely to be of higher capacity and furthermore, there is not then the temptation to underassess the property of a community in order that the community's share of state taxation may be thereby reduced. This, it will be recalled, is one of the administrative difficulties found in connection with the general property tax.

An interesting question in regard to state income taxes has to do with the disposition of the proceeds of such a tax. In Wisconsin the amount derived is divided into three parts, 10 per cent going to the state, 20 per cent to the county, and 70 per cent to the city or township from which the returns are made. Another scheme is to distribute the receipts among the divisions in proportion to the property tax in the different

districts. Some states devote the entire proceeds to school purposes. But most of the states retain the entire tax for the purpose of the state governments. The plan in Wisconsin has a fatal weakness in that certain townships, because of the fortunate location of persons paying large income taxes, have received sums of money far beyond the legitimate needs for public revenue.

It may be confidently expected that the use of income taxes in the various states will increase in the future. The superiority of such a tax, if it is well devised and carefully administered, is so marked that it can hardly fail to increase in importance as compared with the general property tax.

Tax Exempt Securities. — In connection with the subject of income taxation attention must be directed to the tax exempt securities. The prevailing practice in America has been that bonds which are issued by government units should be free from taxation. This practice arose in order to save the useless handling of government funds. If, for example, the tax rate is 2 per cent and if bonds are to be free from taxation, they can be sold, let us assume, on a 4 per cent basis, but if they are to be taxed at the general property rate of, say, 2 per cent, then it would be necessary for the government to issue 6 per cent bonds rather than 4 per cent bonds in order to sell them at par. This would then involve the levying of taxes in order to secure the money with which to pay the interest on the bonds. Under such conditions it is far more preferable to sell the bonds subject to exemption from taxation. This analysis is based on the assumption that the general property tax prevails and that the rate of taxation is proportional to property ownership.

The situation under a progressive income tax is obviously different. Rates under such a tax are higher for the larger incomes than for the lower ones, hence, the income from a government bond if it were taxable might in the case of one person be subject to a tax rate of one-half of 1 per cent, while to another person it might be subject to a tax rate of 20 per cent. That is, the second of these persons might be called upon to pay to the government as tax one-fifth of the income which he receives

from the bond. Under such a progressive tax, the exemption of the income of government bonds from taxation would thus defeat, to some extent, the principle of the progressive rates. The conclusion is that on account of the developing use of progressive income taxation, the old practice of issuing tax exempt securities should be abandoned. All government bonds should be placed on the same basis as the bonds of private corporations. This subject will be further discussed in the next chapter.

State Inheritance Taxes. — All of the states with three exceptions at the present time levy taxes upon inheritances. These taxes are almost without exception levied upon the separate inheritances rather than upon the total estate of the deceased. Further, the general rule is that progressive rates are used, and also that the rates vary according to the nearness of kin of the person inheriting.

Very unfortunately, there is a great deal of difference among the states in regard to the basis of the tax. Some states levy a tax upon the persons inheriting without regard to where the property inherited is located. Other states levy a tax upon the property within its jurisdiction that was owned by deceased persons without regard to where the persons live who are to inherit it. Other states, in the case of the inheritance of property in corporations, levy an inheritance tax if the corporation is located in their borders even though the property owned by the corporation and the persons inheriting stocks and bonds therein are located in other states. Thus it may come about that several different states will levy taxes upon a single estate. In certain rare cases, this might amount to a tax of 100 per cent upon the estate.

It is highly desirable that a much greater degree of uniformity should be secured in the inheritance tax laws of the different states. An effort to bring this about has been made, but thus far there has been difficulty in bringing the state laws into harmony with each other. One plan to accomplish this result would be to have the states give up the administration of the inheritance tax and have the national government collect the tax and remit the funds collected to the proper state. This

method would seem to be highly desirable, but would perhaps be unconstitutional, in the form suggested. This will be discussed again in the following chapter in relation to the national inheritance tax.

Fees and Assessments. — Fees and assessments, as indicated above, constitute a portion of the revenue in the various states and local divisions. In most jurisdictions, this amounts to only some 5 per cent of the total receipts. One significant change which has taken place in respect to fees is that to an increasing degree fees are turned into the treasury rather than retained as compensation by the officials collecting them. That is, officials have been placed upon a salary basis rather than permitted to receive compensation in the form of the fees which they collect in the course of their official duties. The total amount received in fees may not correspond at all to an amount that would represent a proper salary for the official in charge, and in many cases, especially in connection with the administration of justice, it has come to be appreciated that the payment of officials by means of fees often leads to the officials being more concerned in the securing of fees than in the administration of justice.

Assessments in the case of improvements benefiting real estate are generally approved by authorities in public finance. In many cases this may result in injustice as between the persons who own property abutting the improvement and those who own property somewhat adjacent. The latter may receive substantial benefits but under some schemes of assessment they would not be assessed for the improvement. But in spite of the difficulty of equitable adjustment as among different property owners, it seems highly reasonable to levy a special assessment against the owners who are especially benefited as a result of a particular improvement.

Poll Taxes. — Until comparatively recently, most states imposed a flat tax upon each man. The customary amount of this tax was $1.00. This practice has been almost entirely abandoned. In 1925, six states reported the collection of such a tax. In two of these the tax was $1.50 and in the other four, $1.00.

Loans. — Loans constitute an important item in the revenue of most states and local governing units. The increased amount of borrowing during the past few years has been very marked. It is estimated that in 1912, the total state and local indebtedness amounted to \$3,822,000,000, and that by 1922 this had increased to \$8,697,000,000, and two years later, 1924, to \$10,500,000,000.[1] Thus according to these figures, the public indebtedness of the state and local units increased almost threefold during these twelve years. This increase in indebtedness came because of the borrowing of money — the selling of bonds — in order to build schoolhouses, construct roads, build bridges and viaducts, and to make other similar improvements. Incidentally, it is an approved principle of public finance that such bonds should be retired during the life of the improvement that is made as a result of their being sold. It must also be noted that while loans are a source of revenue when the bonds are sold they at once become an item of expense as money is collected to pay the interest and to redeem the bonds when due.

Government Enterprise. — As already indicated, one of the sources of government revenue is found in business enterprises of various sorts. European governments, as noted in a quotation above, have engaged in such enterprises far more than have the governing units in America. The earnings of such enterprises are of small importance in our revenue system as for the most part when government enterprises are undertaken the aim of the government officials is to collect only sufficient money to pay the cost involved, thus not affording anything in the way of net revenue to the governing unit.

PROBLEMS AND EXERCISES

162. Account historically for the general property tax.

163. Account for the fact that the general property tax is retained in most of our states despite the opposition of the students of taxation.

164. What are the leading objections that are offered to this tax?

165. Is it to be expected that the states will make increasing use of the income tax? Discuss.

[1] National Industrial Conference Board, *Tax Burdens and Public Expenditures*, 1925, pp. 62, 67.

166. Develop an argument to the effect that the payment of fees to justices of the peace tends to result in legal injustice.

167. Why do you suppose that the states have almost entirely given up poll taxes?

168. Why should bonds that are issued by a government unit be retired during the life of the improvement that is made as a result of the sale of the bonds?

CHAPTER L

REVENUE OF UNITED STATES GOVERNMENT

The United States Government during the fiscal year ending June 30, 1925, received into the public treasury more than three billion dollars. The peak in United States receipts from taxes came in 1920 when the total amounted to almost six billion

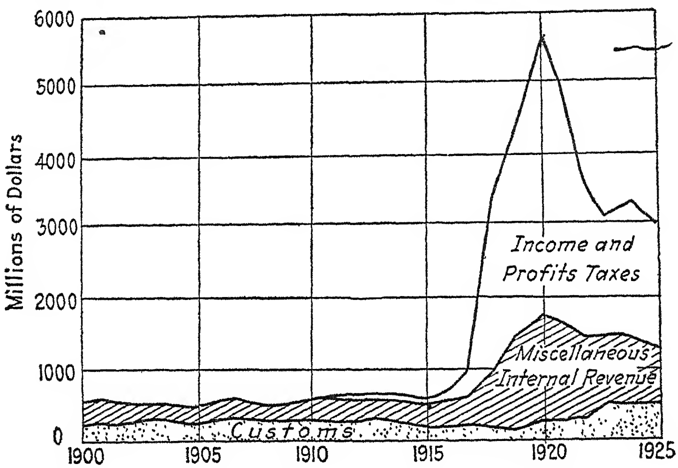

CHART XII. Revenue of the Federal Government, 1910–1925. *Ibid.*, p. 9.

dollars. The receipts for 1925, which were equal to 55 per cent of the receipts for the year 1920, are classified as follows in the report of the Secretary of the Treasury:[1]

	Per Cent
Income and Profits Taxes	47
Miscellaneous Internal Revenue	22
Customs	14
Profits from Foreign Obligations	5
All Others	12

The above diagram gives a classification of the revenue of the federal government from 1900 to 1925.

[1] Report of the Secretary of the Treasury, 1925, p. 8.

The diagram indicates the changes which have taken place in the sources of income to the United States Government. From 1900 to 1913, customs duties represented about one-half of the national revenue, and miscellaneous internal revenue the remaining one-half. The internal revenue consisted almost entirely of taxes upon alcoholic beverages and tobacco, until 1913, at which time a national income tax was instituted. Later, other

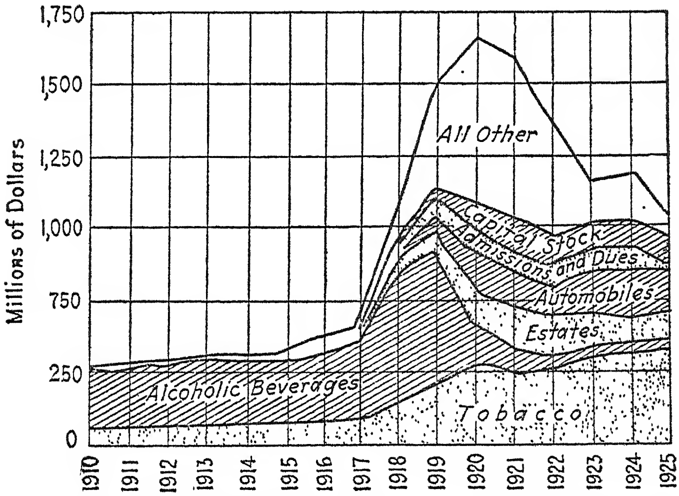

Chart XIII. The Miscellaneous Revenue of the Federal Government, 1910–1925. *Ibid.*, p. 10.

internal revenue taxes were added as is shown in the chart above. The striking thing shown in Chart XII is the part which income and profits taxes bear to-day as compared with the situation of only a few years ago. Since 1922 these receipts from this source should be labeled *income taxes*, as the tax on excess profits was repealed in 1921 to take effect in 1922. As indicated in table 9, the diagram shows that practically one-half of the total federal receipts are now in the form of income taxes. During 1920, almost two-thirds of the revenue came from this tax and the profits tax.

The classification of the miscellaneous internal revenue for the fiscal years, 1910 to 1925, is shown in Chart XIII, which is also taken from the report of the treasury for 1925.

This diagram shows the great increase in these taxes which came during the war, and also the great decrease recently in the amount of taxes received from alcoholic beverages. It is interesting to note that the increase in the receipts from the tobacco tax has within recent years practically equalled the decrease in the receipts from the liquor taxes. The space which is labeled "Estates" represents the receipts from taxes upon the estates of deceased persons — the so-called national inheritance tax.

Another interesting classification from the report already referred to is given in the following table:

TABLE 9

THE DISTRIBUTION OF NATIONAL TAX RECEIPTS, 1791 TO 1925[1]

Period	*Average Annual Tax Receipts*	*Distribution of Tax Receipts*		
		Customs	*Income and Profits Taxes*	*Miscellaneous Internal Revenue*
		Per Cent	*Per Cent*	*Per Cent*
1791–1860	$ 22,254,979	98.6	....	1.4
1861–1909	354,028,988	53.7	2.2	44.1
1910–1916	654,370,098	43.5	8.6	47.9
1917–1921	3,909,695,042	6.3	66.4	27 3
1922–1925	3,307,987,745	15.2	55.8	29.0

The proportion which customs receipts (tariff on imported goods) represent in the total receipts to-day, 15 per cent, is strikingly small as compared with the period ending in 1860, when they represented over 98 per cent of the total.

Constitutional Provisions. — The United States Constitution provides that "no capitation, or other direct, tax shall be levied except in proportion to the census or enumeration hereinbefore directed to be taken." This provision of the Constitution means that Congress cannot levy a direct tax upon the citizens of the various states unless the tax is apportioned according to the number of persons in the respective states. That is, as between

[1] *Ibid.*, p. 11.

a state of ten million population and one of five million population, a direct tax could not be levied by the federal government unless twice as much were collected from the citizens of the one state as from those of the other.

This means that such taxes could not be levied according to the ability principle, for it is almost inconceivable that the population of the various states should be divided in exactly the same proportions into groups with given tax-paying ability. Indeed, the states differ so in per capita wealth, or per capita income, that the constitutional provision amounts to a prohibition of direct taxes by the national government.

But what is a direct tax within the meaning of the Constitution? The justices of the United States Supreme Court have differed in their answers to this question. There has seemingly been agreement from the first that a tax upon land is a direct tax. A tax on carriages, which was really a luxury tax, was in the early years of the government upheld as not being a direct tax. But if a tax on land is a direct tax, is a tax upon the income from land a direct tax? Or is a tax on income, including income from land, a direct tax?

Income Taxation. — During the Civil War, Congress imposed an income tax, which continued until 1877. A case involving this tax came before the Court in 1880 and it was held that the tax was not a direct tax within the meaning of the Constitution. Later, in 1894, Congress passed another income tax law but this was held to be unconstitutional. The Court at that time, by a five to three division, took the position that an income tax is a direct tax. Several years later, an amendment was submitted to the states giving to Congress power to provide an income tax. This became part of the Constitution in 1913, and immediately thereafter Congress established such a tax.

It is interesting to note in this connection that in 1909, a law was passed imposing a tax upon the incomes of corporations. This was declared by Congress to be an excise tax upon the right of corporations to exist, the income of a corporation being used as the basis for determining the value of this privilege. The Court upheld this law as constitutional, thus holding that

what was in effect a tax upon the income of corporations was an indirect tax within the meaning of the Constitution.

The present income tax law really dates from the enactment of the law of 1913 which followed the adoption of the income tax amendment to the national Constitution. The latest revision of the law was made in 1928, and it may confidently be expected that other revisions will be made. This discussion will be in terms of the 1928 legislation. This law makes a distinction between the incomes of individuals and of corporations. A corporation is subject to a tax of 12 per cent upon its net income, above $2000. As noted in a preceding chapter, this rate does not vary among the different corporations.

Individuals are also taxed upon net income. This means that from a person's gross income, certain deductions may be made in order to arrive at net income. The net income of an individual may then be still further reduced by certain exemptions in order to ascertain the income that is taxable at the normal rates. First, there is a personal exemption of $1500 which means that no one is subject to the national tax unless he has a net income in excess of $1500. In addition to this, if one is married an additional exemption of $2000 is given, but the combined personal exemption for husband and wife may not exceed $3500. Further, there is an exemption for each child under eighteen years of age or other person who is dependent upon the taxpayer; and lastly, dividends which are received from corporations that have paid the income tax may also be deducted from the net income, in order to arrive at the income that is taxable at the normal rates.

The tax rates are divided into two parts called the normal rates and the surtax. The normal rates are $1\frac{1}{2}$ per cent on the first $4000 of net income above the exemptions, 3 per cent on the next $4000 and 5 per cent on all above $8000. In addition to these rates, a surtax is imposed upon the total net income, which means the net income before the deductions are made in order to ascertain the income which is taxable at the normal rates.

The surtax rates are as follows: Upon that part of the net

income which is in excess of $10,000 up to and including $14,000, 1 per cent; upon the portion of the income above $14,000 up to and including $16,000, 2 per cent; upon the next $2,000, 3 per cent; and a like increase of 1 per cent for each additional $2000 of income until the rate reaches 6 per cent. After this point, the rates increase more rapidly until the net income is in excess of $100,000. The surtax rate then becomes 20 per cent, which is the maximum rate. In brief, then, the net income of an individual who is subject to the national income tax is broken up into a series of income increments, and each increment is taxed at a rate which is different from the other increments.

The combined tax rate on incomes of $1,000,000 or more, in 1925, of which there were 207 reported for taxation, was 15.83 per cent. In 1919 the corresponding rate was 64.87 per cent.[1] The normal rate is 5 per cent for only part of the net income, and the 20 per cent surtax applies only to that portion of the net income which is above $100,000.

The law makes a distinction between what is called "earned" and "unearned" incomes. By "earned" incomes are meant those which are derived from personal service and by "unearned" incomes are meant those which are derived from property ownership. Incomes, not in excess of $30,000, which are derived from personal services are taxed at slightly lower rates than are those that flow from property ownership. This is accomplished by permitting, in the case of "earned" incomes up to $30,000 a deduction of 25 per cent from the tax which would otherwise have been payable. Thus the rates already considered, strictly speaking, apply only to incomes that flow from property.

Tax Exempt Securities. — In the preceding chapter attention was called to the question of tax exempt securities. This subject has received a great deal of attention in connection with the national income tax. It has been argued that the high surtax rates which prevailed shortly following the war, led to the investment by the rich in tax exempt securities, and thus

[1] *Statistics of Income,* Commissioner of International Revenue, 1927, p. 25.

to the escape of income from taxation. With a surtax rate of 65 per cent on the portion of one's income above $100,000, such as prevailed during 1918, a 4 per cent government bond became more profitable than an 8 per cent industrial security, as the source of the increment of income above $100,000.

The present maximum surtax rate of 20 per cent on the increment of income above $100,000 makes investment in tax free bonds less profitable to the large income receivers than it was under the higher rates. But it still makes the ownership of such securities profitable. As the source of the portion of taxable income in excess of $100,000, a government bond at 4 per cent is equally valuable to an industrial security bearing 5 per cent.

The Secretary of the Treasury estimates that there were $15,946,000,000 of tax free securities outstanding in 1927, of which $11,840,000,000 have been issued by the state and their political subdivisions, $145,000,000 by the territories and insular possessions, $2,165,000,000 by the United States Government, and $1,795,000,000 by the Federal Farm Loan System.[1] It is to be noted in this connection that only the earliest issues of the United States' bonds that were sold during and immediately following the war are free from the surtaxes of the national income tax.

The extent to which the large income receivers have purchased tax free securities in order to reduce their income taxes is problematical. The data available, which come largely from the records of estates liable to the national inheritance tax, indicate that money was not transferred to these securities to the extent that one might have expected. But the fact that this may be done, warrants the conclusion that the policy of issuing tax free securities should be abandoned.

Customs and Excise Taxes. — Shortly following the inauguration of the United States Government, provision was made for the levying of duties upon imports in order that government revenue might be secured. There was no question but that such imposts did not constitute direct taxation and thus there was no question as to their constitutionality, on that score.

[1] Annual Report, 1927, p. 64.

The large part which customs receipts played in the national revenue up until the Civil War has already been indicated.

During the first administration, Hamilton recommended that certain excise taxes should be provided to supplement the revenue from the tariff duties. Excise taxes have always been considered to be indirect taxes and thus a possible source of revenue to the national government. Illustrations of excise taxes, as already noted, are the present national taxes upon tobacco, playing cards, medicinal liquor, and automobiles. These taxes are imposed upon the manufacturers of these products, and are presumably added in to the prices of the articles in question. The national tax on theater tickets is also an excise tax.

Hamilton's recommendation was accepted by an early Congress and a few excise taxes were levied, including a tax on the manufacture of whiskey. These taxes were very unpopular. As stated in the chapters on *money*, the early Americans were stoutly opposed to taxation in any form, if it could be avoided. The "whiskey rebellion" of 1794 was a direct result of these taxes, and shortly thereafter they were repealed.

During the War of 1812, the disorganization of international trade led to a complete cessation of importation and this meant that the receipts from customs duties did not provide sufficient revenue for the government. Excise taxes were then provided for, but were repealed shortly following the termination of the war. Following this time until the beginning of the Civil War, the customs duties continued to be almost the sole source of federal revenue, as they had been in the period preceding the War of 1812.

The Civil War greatly increased the financial burden upon the federal treasury. Further, the war led to a decrease in importation and thus to a reduction in the receipts from customs. Excise taxes were levied and also national taxes were imposed upon incomes as already noted, and upon inheritances. Following the termination of the war, the income and inheritance taxes were abolished and the excise taxes were considerably reduced but not entirely removed as after the War of 1812.

The excise tax upon alcoholic beverages and tobacco remained, and as already indicated, are part of our internal revenue to-day.

In concluding this brief survey of the history of federal revenue, it is well to emphasize the fact that customs receipts are very unsatisfactory as a major source of government revenue, because of the variation in the amount of customs receipts from time to time. Revenues from this source may be greatly reduced during a war as has been amply illustrated from our experience. But during times of peace the change in the amounts of receipts from year to year may also be marked. In 1872, receipts from this source were in excess of $212,000,000 but in 1878 only $127,000,000. In 1882 another high point was reached, over $216,000,000. The low point for the eighties was $178,000,000 in 1885. There was another high point in 1890, when the receipts were more than $226,000,000. In 1894 $129,000,000 was secured, $172,000,000 in 1897, $145,000,000 in 1898, the year of the Spanish-American War, and $202,000,000 in 1899. In 1907, $329,000,000 was taken in, but in the following year only $282,000,000. In 1910, $326,000,000 was secured, but only $180,000,000 during 1918, the last year of the World War.

But not only do imports vary from year to year, tariff rates cannot be altered from time to time to secure the needed amount of revenue. This is true for two reasons: first, the rates are established largely in order to protect home industries. A proposal to alter the rates, especially downward, would meet strong opposition, and at most times could not be accomplished. Second, the relation of rates to the amount of revenue is a very intricate problem. An increase in rates in some cases would reduce the revenue, and in other cases would increase it, and a reduction in rates would likewise produce the one effect in some cases and the other in other cases. The degree of elasticity in the demand for various imported articles, together with the elasticity in the supply of them will determine the effect that tariff changes will have on the volume of revenue. Further, just what is the degree of elasticity can be determined in any one case only by experimentation. During a political

campaign in the late eighties both political parties promised to reduce the surplus revenue which was embarrassing the government, but one proposed to do this by reducing the tariff rates and the other by raising them; and each was equally logical.

The National Inheritance Tax. — A national tax was levied upon inheritances during the Civil War, as already stated, and also during the Spanish-American War. The latter one was repealed within three years of the time of its enactment. The present law dates from 1916 although it has been revised since that date. This tax is, properly speaking, an estate tax not an inheritance tax. The estate of the deceased, rather than the amount that is inherited by the various heirs, is the basis for the tax payment. In most of the states, as already indicated, the tax rates are imposed upon each separate inheritance and vary according to the nearness of kin to the deceased. Under the national law of 1926, no estate is subject to taxation unless after the deduction of certain exemptions, such as gifts for charitable purposes, it is in excess of $100,000. The first $50,000 above $100,000 is taxed at the rate of 1 per cent, and above that amount the rates increase until the maximum is reached in the rate of 20 per cent, which is imposed on that part of an estate that exceeds $10,000,000.

To escape the injustice that would tend to result from the fact that inheritance taxes are imposed in most of the states, the national law permits deductions to be made, from the amount payable to the national government, equal to the inheritance taxes that have been paid to the state governments, up to 80 per cent of the total amount payable to the national government. Thus if the national tax against an estate amounts to $200,000, no more than $40,000 need be paid to the national government if $160,000 has already been paid to one or more of the states.

As indicated in the preceding chapter, an interesting question arises as to the relation between state inheritance taxes and the national estate tax. Many persons insist that the national government should give up this tax and leave the taxation of inheritance to the various states. Such a policy, however, on

the part of the national government, instead of leaving the inheritance tax to the states, would take it away from them, to some extent. This would come about as a result of the competition among the states in respect to this matter. In the state of Florida, for example, there is a provision in the constitution to the effect that the legislature may not impose any taxes upon inheritances. This was obviously included in order to attract rich persons to that state. So long as the national law prevails, such moves on the part of the states can have but little effect, but if we did not have the national law, other states would tend to follow in the footsteps of Florida in order to encourage persons of wealth either to retain or to set up legal residences within their borders. The ease with which a legal residence may be established and maintained in any one state without a person's confining himself to its borders, makes it very easy for a few states, or even only one, to interfere seriously with the collection of inheritance taxes by the other states.

If such a tax is to be used at all, without the aid of the national government, the rates must be very low, except on real estate and other tangible property. And even such property, in the case of rich persons who are not actively engaged in business, can easily be sold and the proceeds invested in similar property in the states where there is no inheritance tax, or where the rates are very low. If the principle of inheritance taxation is sound, and there is seemingly no conclusive argument as to its invalidity, then, it appears that the national government is the proper agency to engage in this form of taxation.

But the state governments are more in need of revenue from this source than is the national government. One solution of the problem is that the states should abandon this tax, and that it should be administered by the national government and the proceeds turned over to the states. This plan would perhaps be unconstitutional. It would seem that the courts would hold that the national government did not have legal power to act in this capacity for the states. The present method of giving credit toward the national tax for the amount paid in state taxes, up to 80 per cent of the total, permits all of the states to make

effective use of the inheritance tax, and this method is presumably constitutional.

Secretary Mellon has recommended that the national inheritance tax be abolished. One point that he makes is that it should be used only as an emergency revenue measure during a war. "We ought not to use our reserves in times of peace," he says.[1] Until recently the national government has used such a tax only during periods of war, but such use of the tax may be condemned as a very unjust method of securing war revenue. The estates of persons who happen to die during such a period are subject to the tax, while the estates of those who die either before, or after, such a law is in effect are not taxed. Further, the transfer of estates by death is in no way related to the exigencies of a war. Increased profits may result from the demands of governments during a war, and so may be very properly subjected to a special war levy. And, likewise, estates may be greatly enhanced during a war, and so fittingly liable to heavy taxation, but the estates of persons who die during a war may not have been at all augmented as a result of the conflict.

PROBLEMS AND EXERCISES

169. Account in a general way for the fact that income taxation on the part of the national government has such a large place in our present revenue system. Why was this not the case forty years ago?

170. What is a direct tax in the meaning of the Constitution? Who is the final authority on this question? Have different answers been made to it? Explain.

171. List the principal reasons as to why the receipts from customs are unsatisfactory as the chief source of government revenue.

172. Develop an argument with illustrations to the effect that the repeal of the national inheritance tax would reduce the use of this tax by the various states.

REFERENCES

Three recent books that give a general survey of the field of public finance are H. L. Lutz, *Public Finance*, 1924; J. P. Jensen, *Problems of Public Finance*, 1924; and M. H. Hunter, *Outlines of Public Finance*,

[1] *Annual Report of the Treasury*, 1925, p. 352. See also report for 1927, p. 51.

1921. H. C. Adams, *The Science of Public Finance*, 1898, is a noteworthy treatise. *Selected Readings in Public Finance*, edited by C. J. Bullock, 1924, contains papers from many eminent writers on the various aspects of public finance. E. R. A. Seligman has written extensively on the subject of taxation. His *Essays in Taxation*, 9th ed., 1921, contains valuable material. The subject is also discussed in the texts that are listed in the appendix.

PART IX

THE DISTRIBUTION OF WEALTH AND INCOME

CHAPTER LI

WAGES

The Subject of Distribution. — We come now to the study of one of the most interesting and important phases of the economic activity of men, namely, the division of income among the members of the economic society. This is generally known by economists as the *distribution* of income or wealth. This meaning of the term *distribution* must be kept in mind as the word is also used in two other senses in economics. It is used in the discussion of marketing to denote the sale or movement of goods from producer to consumer, and it is also used in statistics, and thus in statistics which deal with economic phenomena, to mean the proportion or number of a total number of items that should be placed in given groups or classes. Thus, considering the size of manufacturing plants, as was done in Chapter III, the problem is one of *distributing* the total number of firms among the different groups or divisions. How many firms, for example, employ less than five persons? How many from six to twenty? How many from twenty-one to fifty? And so on.

Since the term *distribution* may be used properly in each of these three cases, care must be taken not to confuse the different meanings. As used here the problem of distribution is that of ascertaining the principles governing the different kinds of economic income.

Kinds of Income. — All economic income may be divided into two classes; namely, income from labor and income from property. These may be subdivided into four classes or kinds: wages, interest, rent, and profit. Wages are derived from labor service, interest and rent from property, and profit is a joint income from labor and property. In the following chapters each of the four forms of income will be considered in order.

It should be clearly noted that all of these forms of income arise out of business relations. Some persons receive income in other ways, for example, by gift or theft, but such receipts are to be regarded as coming from the income — wages, interest, rent, or profit — which other persons receive in their business relations.

The determination of each of these shares of distribution is a price problem. Wages, interest, and rent are all market prices, and profits (or losses) occur because of the prices that prevail. The analysis to be followed here is, then, essentially an analysis of prices. That is, how does it come about that the prices paid (or received) as wages, interest, or rent are as they are? And, why do prices permit profits to be made or cause losses to occur?

Wages Defined. — The term *wages* is most generally used to mean the price paid by an employer for the services of an employee. The word is also used more broadly to mean that part of the income of one who is self-employed that corresponds to what he could get if he should contract to work for another. Thus, a farmer working for himself, a person selling goods on commission, or a physician who gets an income from fees paid by his patients, all receive wages. But if all persons were self-employed, the wage problem would lose most of its significance. It is particularly important in our present society because so many persons are employed by other persons or firms. Indeed, three-fourths of the persons in the United States who are gainfully employed are wage earners (or salaried employees) according to the census of occupations for 1920. And these persons receive approximately 60 per cent of the total national income.[1] The problem of wages is thus essentially one of the amount paid by employers, rather than the amount earned by persons who are self-employed. The following discussion will accordingly be in terms of the wages paid by employers.

A Wage Is a Price. — Since a wage is a price it follows that the wage rate is fixed, as is any price, by the demand for and the supply of the particular form of labor service that is under consideration.

[1] W. I. King, *Incomes in the United States*, Vol. I, p. 99.

The supply and demand forces in the labor market are not as nicely adjusted as in the wheat market, for example. They are often so badly out of balance that a large number of persons are unemployed. In fact, it seldom if ever happens that there is such a nice adjustment of supply and demand in the case of labor, that all persons are employed. As a result of this condition many students in this field have spoken as if wages were not determined by supply and demand. Such statements are unfortunate as they suggest that wages are not prices. Further, they suggest that demand and supply are not operative unless all laborers are employed. Clearly, if some units of labor are withheld at a given wage this in no way means that the forces of supply and demand are not setting the wage. The demand is merely insufficient to call out the total potential supply. Clearly a wage is a price and the problem of the economist is to analyze the demand and the supply sides of the labor market with a view to determining the factors that influence the setting of wage rates. Such an analysis, of course, helps to account for the lack of nice adjustment between the potential supply and the demand. That is, it will, if sound, show the true nature of supply and demand as they operate to set the various rates of wages.

To some people the idea that the price paid for human service is determined similarly to the way in which the price of coal is determined, is repellent. Men are not commodities, we are told, and should not be priced as are commodities. Neither, of course, are men merely objects of a given mass and density, but the law of gravitation applies to them as if they were, and seemingly without giving offense. Labor service is certainly sold for a price, and necessarily operates under the laws of price. Further, since the prices paid for the labor services that produce them are very important in the determination of the prices of commodities, this makes the methods of setting wage rates and commodity prices similar.

Grades of Labor Service. — In discussing wages it is highly important to remember that there are many kinds and grades of labor service. Since no two persons are exactly alike, one

might say that there are as many kinds and grades of labor service as there are persons. In a highly refined sense this is true. Practically, however, differences between certain persons may be so slight that their labor service may be regarded as identical and thus a large number of persons may be included within one wage group. But the differences among persons are such that at the least there are many wage groups. For example, differences in intelligence, skill, strength, reliability, and honesty account for a very large number of groups in the labor market. Then, too, as will be noted presently, there are several factors that condition the relative desirability of being employed in different occupations. This separates the workers in such occupations into different wage groups.

Wages Paid for Single Units. — *The Margin.* — It was emphasized in the chapters dealing with price that buying and selling run in terms of single units, or small lots of goods and not in terms of entire classes or kinds of goods. Similarly, in the matter of wages, it must be remembered that buyers on the one hand and sellers on the other are concerned with single persons or groups of persons and not with entire groups of laborers. Some people are disturbed, as was mentioned earlier, to find that persons in one line of work, say prize fighting, receive a scale of wages that is greatly in excess of the wage received for work that is regarded as of much greater social importance, as for example, school teaching.

A more striking example of this point is found in the fact that agricultural laborers are among the lowest paid workers and yet the social importance of farming gives it first place, or almost first place, at least, among all lines of work. That is, since food is essential to the maintenance of life, the production of food must necessarily outrank almost all other forms of endeavor from the point of view of the contribution made to social welfare, yet farmers' wages are very low. The significant fact is that although the work of farmers as a class is of primary social importance, the work of any one farmer is of but very little importance. Normally, at any one time most persons engaged in farming are definitely committed to the farming

business. Thus, the buyers of farm labor or farm products need to be concerned only with the relatively small number of persons who are likely to leave the farms, or the few, relatively, who may be attracted away from other lines of work to farming. That is, in bidding directly for farm labor, or in bidding indirectly for farm labor through the purchase of farm products, it is only necessary to pay enough to attract to, or to hold within the farming group enough persons to keep a proper balance between the products to be derived from this occupation and the products of all other lines of work. In short, only such an amount need be paid as represents the wishes of marginal employers of farm laborers or of marginal buyers of farm products.

Likewise, with all grades or kinds of work, it is the persons who are at or on the margin as employees and as employers who are significant in setting wages. The supply in view of the demand sets prices in the labor market as in the markets where commodities are bought and sold. The wage cannot be more than the marginal employer will pay, nor less than the marginal employee will take. It may thus be less than many employers would pay and above the amount that some of the employees would take. One employer might be willing to pay $10 per day for skilled machinists, but if other employers will pay only $7 per day, and if there are so many machinists that some must work for the low wage employers, all of the machinists will tend to get only $7 per day.

If more machinists should now appear in the market, and if they were willing to work for less than $7 per day, they would bid down the wage rate for all of the machinists. On the other hand, if employers should wish to increase the number of their machinists, they would tend to bid up the wage. In this way the more prosperous firms may entice machinists away from other firms, and men from other fields may be induced to enter this line of work.

To get a picture of the different labor groups consider a manufacturing business employing 4000 or more persons. In such a situation wages normally vary all the way from $1.50 per day to $15,000 or $20,000 per year. We may assume that

the firm pays no more than it needs to pay for each type of service. The common laborers, machinists, tool makers, inspectors, department superintendents, stenographers, and the plant physician, along with the various other employees, all tend to get a wage that is set at the margin for each group. If stenographers get less than do tool makers this is because the supply of the one kind of service, in view of the demand for it, forces the wage to a lower point than in the case of the other kind of service. Wages, to repeat, conform to the elementary principle of the pricing of commodities.

One familiar phrasing in economic literature is that the wages of each group tend to equal the *marginal productivity* of the laborers, that is, the value to the employer of the marginal item of their product. A more refined phrasing of this idea is that wages tend to equal the *discounted marginal product*. The work of laborers seldom issues into a salable product until some time after the work is performed: they are almost invariably paid before the employer sells the product which they produce. Thus the maximum wage which he can afford to pay is not the equivalent of the value of the final product, but the equivalent of the present worth of the final product — the discounted value of the final product.

But it must be understood that, so far as many employers are concerned, they can have no appreciation of the marginal productivity — or the marginal worth to them — of any group of laborers. Consider an employer who is operating a machine shop with the assistance of 1000 persons. How much is one of his lathe operators worth to him? One of the tool makers? An inspector? This problem is as nearly insoluble, so far as many factories are concerned, as is the problem of finding the value of one egg, or one spoonful of baking powder, or one cup of sugar to a cake baker. Each one of the items that are essential, if the others are free, may be said to be worth the value of the total product, but that could not be its value if the other items are not free. If the ingredients of a cake are to be worth $1.00, the baker would pay $1.00 for the necessary sugar, if the other items are free; but if all of the other items are to cost 90 cents,

the baker cannot afford to pay more than 10 cents for the sugar. What each ingredient will contribute in value — what the baker can afford to pay for it — will depend on the price of the other ingredients, and the value of the cake. Similarly, any part of the labor force that is necessary to an establishment cannot be valued by an employer apart from the remainder of the force.

Despite this limitation, the marginal idea does have validity. In fact, it is fundamental to an analysis of the situation. Not all labor crews are fixed in proportions. Some employers may be able to use effectively several different combinations. Whether 25 or more machinists up to 30 shall be employed in a given shop may depend entirely on the wages of machinists; whether 10, 11, or 12 handy men shall be hired may also depend solely on the wages that are demanded. And even if all labor crews were of fixed proportions, some employers would undoubtedly be at the margin of hiring one crew more or one crew less. It is extremely unlikely that there is a single line of work in which some of the persons who engage in it are not on the margin of being unemployed. The wage rates which the employers of such persons will pay are of vital significance in the wage bargain. These employers are, of course, the marginal ones. They, together with the marginal employees in each group, determine the wages throughout industry. The marginal employees are, obviously, those who will take employment only at certain rates. If rates are cut they tend to remain unemployed, or to seek employment in some other line of work.

To refer to the cake illustration again, the prices of eggs, sugar, etc., are similarly set at the marginal uses for each item, so far as the offers of buyers are concerned. These offers to buy at certain prices, together with the offers of marginal sellers, or producers, to sell at certain prices, determine the prices that prevail. Most of the buyers and most of the sellers then accept these as a matter of course.

This analysis of the wage bargain, it must be emphasized, is in terms of tendencies. There is not a delicate balancing in the

labor market. Custom is especially strong here. Both employers and employees may come to regard certain wage rates as just and reasonable, and not press for changes when they might be made. The wage bargain has a far larger personal element in it than is true of bargains in respect to the purchase and sale of commodities. One element in this is that a very considerable number of wage earners are not primarily interested in making money. They must, of course, have some money, but having some they are not concerned about getting more. Hence, they do not attempt to secure wage advances, nor are they concerned to retain their jobs if they have a little money ahead. This is not true of all laborers, but it is perhaps true of far more of them than the usual person who is "money conscious" suspects. It is especially true of non-union groups of common laborers, and of women who are only partially self-dependent. Hence, the wages of such groups may easily be below the rate that the market would permit.

Trade unionists, in contrast with the laborers just mentioned, tend to be wage conscious. The process of unionization increases the interest of laborers in the wage bargain, and the maintenance of interest in the union calls for continuous emphasis by the leaders on the terms of employment. In short, trade unionism gives to the wage earner something of the business point of view of the employer. It makes him interested in making money — in driving the best bargain that he can. Trade unionists thus usually get in wages all that the market will afford.

Wage Rates and Different Employments. — As already emphasized, wage rates vary from one employment to another. The publications of the United States Department of Labor show great difference in wages within employments and from one section of the country to another. One should, however, be slow to conclude that these rates are for identical service. Two neighboring shops carrying on the same kind of work may pay different rates, but they may employ somewhat different types of laborers. The higher wages of the one may permit it to secure a better grade of employees than the other one has.

Yet, as emphasized previously, wages are not adjusted on delicate scales. But despite this fact, there is always a tendency for the rates in different lines of work to become equal to each other. This is due to the general force of competition as indicated in Chapter II. If wages are high in certain employments, laborers tend to enter such fields. This permits employers in such lines of work to reduce wages. Likewise, if wages are low in certain industries, laborers tend to leave such lines of employment. Thus through the shifting of marginal laborers in the different lines of work, wages for unskilled labor tend to be equalized throughout the different employments. This equalization of wages is further facilitated by the supply of labor in the different fields being adjusted through the numbers of persons who are constantly dropping out of industry, and the number who are entering. Entirely apart from any shifting of laborers this would tend to equalize wages.

There is another interesting aspect to the equalization of wages among industries. If higher wages are paid in one line of work than in others, this is likely to be due to the fact that the business in question is very profitable. This would mean that new firms would tend to enter this field and that the other firms would extend their scale of operation. The result of this extension of business would force down the price of the output and by reducing profits make it impossible for employers to pay as high wages as they were formerly able to pay.

Similarly, extremely low wages in some one employment usually mean that such work is not profitable and that the most inefficient firms are being eliminated. The consequent reduction in output would tend to mean higher prices, larger profits, and ability to pay higher wages than could have been paid when the industry was overcrowded.

This tendency to uniformity is, however, only a tendency. Lack of ability on the part of laborers to bargain shrewdly, to move from one district to another, and perhaps most of all an inclination to be not greatly concerned as to what wages are received, operate to make wage rates differ sometimes very appreciably even in neighboring shops.

The Elasticity of the Demand for Labor. — The adjustments that have been described as taking place in the wages of the different groups, may also be stated in terms of the elasticity of the demand for the services of the different groups of laborers. There are, obviously, limits to the wages that may be paid in any group. Persons who have money to spend directly for labor service, or indirectly for labor service through the purchase of goods, distribute their money among the different labor groups. What they will pay for one type of labor service, or for one commodity, will in most cases depend upon what they can get for their money if they spend it differently. This means, of course, that the different kinds and groups of labor are competing with each other for the consumer's dollar. In the matter of house-building, for example, the wages of bricklayers may be such that persons will prefer to hire carpenters to build frame houses rather than employ masons to construct houses of brick. Or, the wages throughout the building trades may be such that persons will give up something in the way of house accommodation in order to purchase commodities of an altogether different sort.

The Supply of Labor in Different Wage Groups. — The discussion thus far has been largely, although not entirely, in terms of the demand for labor service. Attention will now be directed to a consideration of some of the factors governing the supply of laborers in the different labor groups.

(1) *Ability.* — In the first place, it may be noted that the number of laborers in certain wage groups is definitely limited because of the ability that is required to perform the particular kind of labor service demanded. The differences among persons, so far as ability is concerned, is determined by several factors For one thing, natural endowment varies greatly. One person may be by nature fitted for a certain task while another may be disqualified for it because of his inherent characteristics.

Training is also an important factor in determining the ability of persons to perform particular tasks, and this is determined in part by the economic ability of persons to pursue the course of training that is required. Our present day system of

liberal public support of the educational system makes it more and more possible that the children of persons who have very low incomes may receive training which some years previously would have been denied them. Still, after all allowance is made for free tuition, and in many cases free books, it remains true that the economic handicap prevents many persons from pursuing studies for which they are naturally well endowed. As a result, certain of the better paid labor groups have fewer numbers relatively to other less well paid groups than would otherwise be true.

Furthermore, the number in a group requiring a certain ability may also be limited because of age or sex. Thus for various reasons the number of laborers in certain wage groups is relatively small in proportion to other wage groups, and as a result the wages paid are correspondingly higher than the wages that are paid for other types of labor service.

(2) *Compensating Advantages Among Occupations.* — Second, the relative number of laborers in the different wage groups is affected by the advantages and disadvantages that prevail among the different lines of work. Six conditions that go to determine the relative desirability of occupations will be indicated.

In the first place, the laborers in certain lines of work are at a relative disadvantage as compared to other laborers because the opportunity for continuous employment is less than that which generally prevails. In the building trades, for example, a great deal of time is normally lost by laborers because of weather conditions. The work of the coal miner is also subject to very frequent interruptions, partially on account of the inability of the railroads always to procure cars into which the coal may be loaded. Such a condition tends to reduce the number of persons seeking employment in such lines of work, and accordingly tends to raise the level of wages in such occupations above the rate which prevails in similar lines of work which are not under the handicap of broken employment. Putting this same matter differently, the fact that laborers entering such fields may be denied full employment tends to cause laborers to

refuse to go into such occupations unless the wage rate is fixed above the rate which they could command elsewhere.

Second, the very opposite condition is a factor in determining the number available for employment in certain occupations. What is commonly designated as "security of tenure" prevails to a high degree in the teaching profession. The general rule is that if a person, during the period of apprenticeship, performs his work in a satisfactory manner, he will be retained indefinitely. Similarly, in the civil service branch of government work, one's position is to a very high degree an assured one after a short apprenticeship has been served successfully. In most occupations, the prevailing condition is in marked contrast to that which has just been indicated, for the usual employee is subject to dismissal by his employer at any time. As a result, the lines of work in which there is a high degree of security are relatively well supplied with applicants for positions, and consequently wages tend to be below the rate that prevails in most lines of work for labor service of a similar degree of ability. In other words, the fact of security of tenure prompts individuals to accept employment at a wage below that which could be secured in another line of work in which the position is less secure.

In the third place, occupations differ greatly so far as the social prestige of work is concerned. There is, for example, a wide difference in this respect between what are commonly called "white-collar" or "soft-handed" jobs and the "overalls" or "horny-handed" lines of work. The social prestige attached to one line of work as compared with another tends to increase the number of applicants for the positions that are favored socially, and consequently tends to reduce the rate of wages therein. An illustration of this is seen in the work of bank clerks. This group of persons is notoriously poorly paid. This comes about because the prestige attached to the work of the banker is such that many young men apply for positions in banks, and are willing to accept work there at lower wages than they could procure elsewhere. This consideration also helps to explain the high wages that prevail for domestic servants. This kind of work is so lacking in prestige that most young women prefer

to take positions in industrial or financial establishments rather than in households, although the wages received in the one may be very small as compared with the wages that might be received in the other. An illustration of the influence of prestige from the opposite end of the economic scale is seen in the readiness with which positions of great trust and responsibility in the national government are accepted by individuals who could command as wages perhaps a great many times as much per year as they can get from the government.

Fourth, the hours and working conditions that prevail in different lines of work have an important influence in determining the relative wage rates. For example, the number of hours of work required per day and per week, regulations governing holidays and yearly vacations, and general conditions such as cleanliness, noise, risk of accident, and courteous treatment are all factors that influence persons in the choices that they make among occupations. These factors accordingly help to account for differences in wage rates.

Fifth, if there is a chance of securing large gains in an occupation, such a large number of persons may be attracted to it that the wage rate may be very low for most persons. In many of the professions a few persons are highly successful. Their success attracts to such work a very large number of persons and, as a result, the numbers are so great that so far as the large bulk of persons are concerned, the economic return is very meager.

Finally, it may be noted that the opportunity to be independent, to achieve some goal, or to accomplish some task, may prevail to such a degree in some lines of work that many persons will be attracted to them, with the result that wage rates will be lower in such occupations than in lines of work that are otherwise similar.

(3) *Restriction upon Movement from One Group to Another.* — A third general factor that determines the number of persons within the different wage groups and that thus affects wages, is the restriction that is placed upon the movement of persons from one group to another. There may be marked

differences between the wage rates in different parts of the country as a result of the immobility of labor. Adam Smith observed, in his *Wealth of Nations* (1776) that of all forms of baggage the laborer was the most difficult to move. While modern transportation has greatly facilitated the movement of laborers, there is still a relatively high degree of immobility in labor groups. Laborers and their families can normally move from one place to another only with great inconvenience and at considerable expense. This, added to the strength of home ties, operates to prevent shifting from one part of the country to another in order to take advantage of differences in wage rates.

The establishment of monopoly or quasi-monopoly conditions in a labor group also restricts the movement of laborers. Trade union control in certain lines of work tends to have this effect. That is, the persons who are already members of a union may prevent other persons from taking membership within it, and through the control which the union exercises over the possibilities of employment, the number of available laborers may thus be curtailed and wage rates accordingly kept at a high level as compared with wage rates in similar lines of work. Then too, a like condition may prevail because men are preferred to women for certain lines of work for which women are just as well fitted as men. In so far as this is true, it results, of course, in keeping the wages in such an occupation at a higher level relatively to the wages paid in other groups than would be true if women were free to enter that line of work.

(4) *Holding Out for Standard Wages.*— The fourth general factor conditioning the supply of labor that is offered in different occupations and lines of work is the insistence upon securing a particular rate of wages. Indeed, one of the most significant things about the labor market is the tenacity with which any labor group will hold out for a customary wage. This is very apparent in a period of industrial depression when many persons are unemployed. Although in such a time the need for income may be very pressing, yet most persons, until they are driven to it by dire necessity, refuse to accept a rate of wages

below that which they have been accustomed to receive. Each person, in such a situation, is prompted to refuse to accept a wage reduction not only because of his own desire but because of the strong social pressure upon him from his associates not to cut the established rate of pay.

The Wages of Men and Women. — One aspect of the problem of the supply of labor in the different groups, as suggested above, concerns the sexes. This may be discussed from the point of view of the wages received by men and women. The wages received by women are almost invariably less than the wages of men beside whom they work. This differentiation in wage payment has led to an insistent demand on the part of many women that, as between the sexes, there should be "equal pay for equal work." The implication in this statement is, of course, that payment is not equal for equal work. In other words, it is implied that women do the work in question as well as men do it, and yet are paid less than men receive. But an analysis of the situation suggests that this is not the case. The issue could hardly arise unless both men and women were doing the same kind of work. If the two sexes do the work equally well, the employer could then dispense with the men and hire only women. Since he is paying the women less than he is paying the men, this substitution of women for men would enhance his profits. But he does not do this. He continues to employ men rather than fill their places with women. The additional women, whom he might employ, we may assume, are equally as able as are the women already employed. Hence, if we assume that he is actuated by business motives, he must find, or believe, that the men whom he employs are worth more to him than are the women who work along with them. In other words, he must regard the work of the two sexes as unequal.

The superiority of men, as compared with women, in the eyes of the employer may be based on such considerations as the physical strength of men. Thus in case of the breaking of a machine or other similar emergency, men might be able to serve the employer better than women could. But to some extent employers may be merely following traditional habits in

preferring men to women. Also in many employments where contact with the public is concerned, as in banking, for example, the attitude of preference for men rather than women may be traditional rather than based on genuine superiority. Such attitudes tend, of course, to reduce the number of women in certain employments and thus, by reducing the total number of employees therein, tend to make the wages in such work higher than they would otherwise be. Also, this tends to increase the number of women in the groups from which they are not excluded and, hence, lowers the wage rates in such employments.

The general differences between the wages of men and women are indicated by data published by the United States Bureau of Labor Statistics.[1] In factory employments in the state of New York the average earnings in shop work in 1926 were found to be $33.17 per week for men and $18.73 for women. The ratio was almost two to one. The lowest earnings for women were reported to be in beverages, $10.58 per week, and the highest in furs and fur goods, $32.04 per week. The range for men's work was from $22.07 in tobacco products to $56.83 in miscellaneous stone and mineral products. These data are for earnings and not for wages. Thus they do not accurately reflect differences in wages as women suffer more unemployment than do men.

A study of office workers in Massachusetts which was based on wages, not earnings, shows only 10.8 per cent of the women as compared with 59.9 per cent of the men getting $30 and over per week; and only one-half of 1 per cent of the women, as against 18.3 per cent of the men, getting $50 or more per week.

Money Wages and Real Wages. — We usually, of course, think of wages in terms of money, as in considering any other service or commodity that is bought and sold. But in the case of wages it is often desirable to consider not simply the money received but the quantity of goods that can be bought with the money wages. Wages thus measured in commodities are called *real* wages. This is an important concept in considering the

[1] Bulletin No. 439, pp. 647–649.

relative position of a given grade of labor at two different periods of time. For, due to changes in the level of prices, money wages may be of no significance in comparing the well-being of laborers at two different dates. Also in comparing wage rates that prevail in different countries, the quantity of commodities that may be purchased with the money wage is normally of much more significance than are the rates expressed in terms of money. In these chapters the word *wages* will be used when money wages are meant, and the expression *real wages* will be employed to indicate the purchasing power of money wages.

Wages and the Product of Labor. — The wages that have been received by laborers in America from the beginning of this country have been higher than the wages paid abroad. This has been true not only of money wages but of real wages, too. The explanation of this difference is that the output of labor, measured in commodities, has been uniformly high in America, as compared with other countries. This has made it possible for the employers to pay higher wages measured in goods than could be paid in other countries, and further, the force of competition, as it has operated among employers, has forced them to pay high wages, although not always as much as was warranted by the product of labor.

The difference in the real wages that prevail to-day in America and Europe are roughly indicated in the following table. These data were compiled by the International Labor Office, as of October 1, 1926. The United States Bureau of Labor Statistics says of these data:

"The figures given are in the form of index numbers, using London as the base or 100. In considering the figures presented it is very important to note that the wage data relate only to a very few categories of workers (building, engineering, furniture, and printing and publishing) and the price data are limited to certain articles of food and to rent. Thus, the index numbers can be taken only as a very rough indication of the relative levels of real wages of adult male workers in certain occupations and cities. In many instances, however, the figures shown indicate such wide differences between cities that they may be accepted as reflecting real differences in the level of well-being of the workers in different countries."

TABLE 10[1]

INDEX NUMBERS OF COMPARATIVE REAL WAGES IN VARIOUS CITIES, OCTOBER 1, 1926

[London, October 1, 1926 = 100]

City	General Average Index Numbers		City	General Average Index Numbers	
	Based on Food Only	*With Allowance for Rent*		*Based on Food Only*	*With Allowance for Rent*
Philadelphia	183	183	Warsaw [3]	55	56
Ottawa . . .	159	157	Prague . .	50	53
Sydney	137	137	Riga.	50	53
Copenhagen . .	125	125	Lodz . .	49	54
Dublin . . .	100	109	Rome [4] .	46	48
London	100	100	Brussels . . .	44	47
Amsterdam . .	96	96	Vienna . .	44	50
Stockholm [2] . .	92	90	Tallinn . .	43	44
Oslo	80	82	Lisbon [4].	32	. .
Berlin	69	63			

[1] Bulletin, No. 439, p. 808.

[2] The figures are based on wages in the building, furniture-making, and printing industries only. For other cities the metal industry is also included.

[3] Based on a weighted average wage. For other cities an unweighted average has been used.

[4] The figures for Lisbon and Rome are relatively low. This may be accounted for in part by the differences in the items of food consumption in the southern European countries from those ordinarily consumed in most of the other countries included in the table.

It will be noted that the American city in the list, Philadelphia, showed a rate of 24 per cent above any other city, and that the second city is Ottawa, Canada, and the third, Sydney in Australia. The European cities, with the exception of Copenhagen, Denmark, are credited with a wage far below the figure for Philadelphia. Rome, and Brussels, and Vienna, and Prague are shown to have a real wage level that is less than half that of London and only from one-third to one-fourth that of Philadelphia.

The relation between the product of industry and real wages may be further analyzed by omitting the employer from analysis. Fundamentally, laborers hire each other. If each of the groups of workers producing food, clothing, shelter, furniture, etc., have a high productivity measured in goods, the exchange of products will, obviously, give to each group a larger sum of goods than it could have if the output were less.

The employer is, of course, the central factor in the determination of wage rates. Laborers may normally have employment only when employers wish to employ them, and only at wages that the employer is willing to pay. But it must be appreciated that in a sense the various employers are agents for the various groups of the employees, and the earnings of one group are largely determined by the earnings of the others. This becomes clearer by noting the large proportion of the total economic income in the United States that is received in wages.

The National Bureau of Economic Research has estimated that the amount paid out to hired laborers in 1918 was 54 per cent of the net value product of all industry, and that this share had not fluctuated more than 2 per cent during the previous nine years. The net value product in every case was determined by deducting the cost of raw materials and other expenses from the selling price of the product. It will be noted that this reference is to hired laborers and thus that the figure given does not include the return from the labor service of farmers, manufacturers, shopkeepers, and others who were working for themselves. If the wages of these groups were included, the proportion attributed to wages would be appreciably augmented. In agriculture, for example, the wages paid out represented only 10 per cent of the net product, as a large part of the farm labor is performed by farmers and their families.

More significant data are found in the fields of manufacturing, mining, and transportation since the corporate form of organization prevails in these fields and this makes the ascertainment of actual wages highly exact, for there are but relatively few self-employed persons in these groups. In these fields, wages, including so-called salaries, represented 77.3 per cent of the

net value product in 1918, and rent, interest and dividends 22.7 per cent. From 1909 to 1918 the amount represented by wages in these three lines of industry was over 70 per cent of the net value product in six of the ten years. The lowest point was reached in 1916 when wages equalled 66.7 per cent of the net value product.

Quite necessarily, therefore, the wages that any one group can command will be determined to a considerable degree by the wages that the general group of laborers receive. In other words, the wages that any employer can pay and, as well, in most lines of industry, the profits that he can make from the sale of his product, depend, to a considerable extent, upon the general rate of wages that are paid throughout the economic system. Of course, in the case of any particular employer, it is advantageous to pay the lowest wages possible for a given amount of work, but it is certainly to his advantage to have other employers pay high wages in order that the demand for his products may be thereby increased, unless, of course, he should be engaged in one of the few lines of production for which the market is found exclusively among the upper economic class, and even then his market might be improved indirectly if wages were high.

The relation between prosperity and the demand for labor which has just been indicated helps to explain the effect of mechanical improvements upon wage levels. Laborers often oppose the introduction of labor-saving machinery on the ground that it will reduce the possible field of employment. This may very well be true over a short period of time, as was explained in an earlier chapter. However, the saving effected by such machinery will necessarily give to the producers, or the consumers, of the good in question a larger fund of buying power than they would otherwise possess. This will be expended, in part at least, in the purchase of products which labor will be called upon to produce. Thus not only may unemployment not be expected to follow the introduction of machinery, but the rate of wages, measured in terms of goods purchased with the money wages, will be augmented if industrial equipment increases the efficiency of industry. Clearly, as the volume of

product is increased, a larger quotient per capita is available to the people of a nation. To be sure, the other income receivers in an industrial society may gain in such a case at the expense of the labor group, but since laborers normally receive approximately three-fourths of the total social income in this country, it is almost inevitable that a gain in productive efficiency will benefit this group to some degree. This discussion will be continued in the following chapter.

PROBLEMS AND EXERCISES

173. "The wage of any class of labor is set, as is the price of wheat, at a point that will just clear the market." Is this true? Discuss.

174. Draw a supply and demand curve to show that the wages of machinists will be \$7 per day and also that some employers would be willing to pay as much as \$10 per day.

175. Illustrate the term "discounted marginal product" by reference to the wages that farmers can afford to pay during the corn planting season.

176. (*a*) Give an original illustration to show that an employer in certain cases cannot determine the productivity of his different laborers.

(*b*) Give another original illustration to show that an employer in certain cases can determine the productivity of his laborers.

177. "There is not a delicate balancing in the labor market. Custom is especially strong here." Do you agree? Discuss, giving illustrations.

178. Show how it comes about that wages in the different branches of the building trades tend to be approximately the same.

179. Illustrate the elasticity of the demand for labor by citing two kinds of labor service for which the demand of one is more elastic than is the demand for the other.

180. Give illustrations of the points made in the text relative to the supply of labor in different wage groups.

181. How do you account in terms of population for the difference in real wages in the various cities of the world as indicated in table 10?

182. "High wages in one group lead to high wages in other groups." Discuss pro or con.

CHAPTER LII

WAGES (*Continued*)

Trends in Productivity and Wages. — In the preceding chapter the relation between productivity and wages was emphasized. It is interesting, in connection with that analysis, to note the finding of the United States Bureau of Labor Statistics in regard to the changes in efficiency in American industry during the past three decades. The productivity indexes for eleven industries are shown in the table below. Concerning the terminology used in connection with the table the Bureau says:

"The 'productivity' of labor must be clearly differentiated from the 'efficiency' of labor, or from any term which is narrowed down to express only the output due to the ability and willing coöperation of the workers themselves. It is of the utmost importance that these two ideas be kept clearly distinct. The notion of labor productivity contains no implication as to the causes of the large or small output; the laborer is simply used as the unit of measurement in expressing the technical progress or decline in an industry over a period of time, regardless of whether the changes in output were due to new machinery, managerial skill, or better work by the employees." [1]

It will be noted that the gain in efficiency in the making of rubber tires is shown to have been greater than that which took place in any of the other industries. The increase here was 211 per cent. The boot and shoe industry shows the least increase of efficiency of the entire list. The index of efficiency for this industry in 1925 was only 6 per cent above that of 1899. With the exception of the boot and shoe industry, it will be observed that not one of the other ten industries shows a gain in efficiency of less than 26 per cent between 1914 and 1925.

In the same bulletin,[2] the Bureau gives the results of a

[1] Bulletin No. 439, p. 527. [2] P. 536.

study of the production of cotton cloth in a New England cotton mill for which records have been kept over a long period of years. The number of pounds of sheeting produced per man-hour was shown to be as follows for the years indicated. In

TABLE 11

INDEXES OF PRODUCTIVITY OF LABOR IN 11 INDUSTRIES[1]

[1914 = 100]

Year	Iron and steel: Industry as a whole	Iron and steel: Blast furnaces	Iron and steel: Steel works and rolling mills	Boots and shoes	Leather tanning	Slaughtering and meat packing	Petroleum refining	Paper and pulp	Cement manufacturing	Automobiles	Rubber tires	Flour milling	Cane-sugar refining
1899	60	44	63	100	93	...	62	..		..			. .
1904	69	59	71	108	92	...	57	82	...	40	...	94	...
1909	100	80	104	100	92	115	117	95	. .	36	...	93	...
1914	100	100	100	100	100	100	100	100	100	100	100	100	100
1915	120	..	.		..	.	. .		...		.		...
1916	124	. .	. .	.	. .	.	.	.	..	120			...
1917	109	...	..	..		. .	.	101	..	133	.	.	...
1918	103	...		...	98	.	.	101	...	90[2]	...		...
1919	100	96	101	105	101	93	92	104	103	136	130	96	79
1920	115	...	.	...	99	...	. .	102	. .	150	. .	...	. .
1921	94	110	92	115	126	119	111	94	124	193	190	118	82
1922	136	..	...	116	130	125	126	118	...	249	...	...	...
1923	139	154	137	107	134	128	135	116	132	270	266	128	102
1924	137	..	...	107	131	129	163	128	143	262	301	...	114
1925	159	..	159[3]	106	126	127	183	134	161	272	311	136	128

[1] *Ibid.*, p. 545.

[2] This figure is not representative of productivity in the automobile industry in 1918 because of the fact that the government, for war purposes, placed a restriction on the number of cars which could be produced. In addition, many manufacturers were extensively engaged in executing war orders.

[3] Estimated. For details, see December, 1926, issue of the *Labor Review*, pp. 31, 32.

1838, 0.98 pound; in 1850, 1.21 pounds; in 1890, 3.31 pounds; in 1919, 4.98 pounds; and in 1925, 7.53 pounds. The marked increase in output in 1925, as compared with 1919, is to be accounted for by the construction of a new plant that is equipped with the latest machinery available. This affords a striking

illustration of the increased efficiency made possible in the cotton industry by the improvements which have recently been made in machine technique. If all of the mills could be equipped with modern machinery, the increase in output would be very marked indeed. This increase in efficiency in the manufacturing of sheeting is perhaps somewhat comparable to the increase which has taken place in many individual plants in various lines of industry, and has made possible the average gain in output that is indicated in the above table.

The analysis above was to the effect that we should expect that an increase in the efficiency of our industrial processes would result in an increase in wages. It is interesting to note the changes which have taken place since 1913 in money wages, and also in real wages in American industry. The following chart is taken from the bulletin of the United States Bureau of Labor Statistics from which several quotations have already been made.

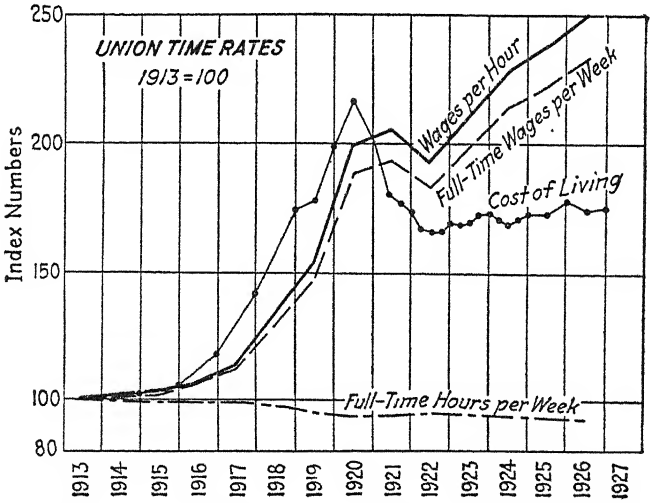

CHART XIV. Union Wages, Cost of Living, and Full-Time Hours per Week, 1913–1926. *Ibid.*, p. 705.

This chart applies to the following groups of labor: the building trades; chauffeurs, teamsters and drivers; granite and stone cutters; laundry workers; linemen; longshoremen; the print-

ing and publishing trades; and street railway motormen and conductors. It is to be noted that wages advanced steadily from 1913 until 1921, and fell from 1921 to 1922, but after that date advanced again. In 1926 the union rates per hour were two and one-half times as high as they were in 1913. The cost of living curve in the chart, in relation to the wage curve, indicates the changes in real wages since 1913. Until 1920 the cost of living advanced more rapidly than did wages. This means that real wages fell during this period. But since 1920 the cost of living line has been below the line of wages on the basis of equality in 1913. The cost of living curve has followed a relatively straight line since 1922, during which time wages per hour have been advancing. This means that real wages have been increasing during this period. The average rate of wages per hour for all of these trades is given as $1.148 in May, 1926. The chart also shows that the hours to be regarded as a full-time week have decreased during this period.

The changes in the rates of union wages per hour in the building trades are given by the Bureau in the following table:

TABLE 12[1]

INDEX NUMBERS OF UNION RATES OF WAGES PER HOUR IN THE BUILDING TRADES

[1913 = 100]

Year	*Index Numbers*	*Year*	*Index Numbers*
1913	100	1920	197
1914	102	1921	200
1915	103	1922	187
1916	106	1923	207
1917	113	1924	224
1918	126	1925	233
1919	145	1926	248

This shows the average rate of union wages in the building trades in 1926 to have been 24 per cent above the rate for 1921, and almost two and a half times as high as the rate in 1913.

[1] P. 710.

The Bureau's study includes many other branches of labor, and in almost every case marked increases in wages are indicated. Farm wage rates are shown to have risen less than 100 per cent from 1913 to 1926. The index number for the latter year is 171. Wages in sawmills are given as 168 in 1925 on the basis of 100 in 1913, but the other data all show an increase of over 100 per cent during this period. In the men's clothing industry, the earnings per hour are given as almost three times as high in 1924–1926 as in 1913. Workers in the woolen and worsted goods industry are credited with earnings per hour of 242 in 1926 on the basis of 100 in 1913. In 1920 the index number was 304. The slaughtering and meat packing industry is shown to have almost doubled the wage rates between 1917 and 1925.

Wages in terms of dollars are still low, however, despite the increases that have been made. The average earnings per hour in the men's clothing industry is put at $0.75 for 1926 and the average full-time weekly earnings at $33.23. In the woolen and worsted industry the corresponding figures are $0.491 and $24.21 respectively. The wages in slaughtering and meat packing are given as practically the same as those for the woolen and worsted industry. The average hourly rate in the building trades is given as $1.278 for May, 1926.

Stability of Wages as Compared with the Price of Commodities. — The nature of the wage bargain may be further indicated by noting the stability of wages as compared with the prices of commodities. It is invariably found that in a period of rising prices wage changes do not keep pace with the changes in commodity prices, and likewise, that in a period in which commodity prices are falling, wages tend to fall much less rapidly than do the prices of commodities. In a period of rising prices real wages thus tend to fall, whereas in a period of falling prices, real wages tend to increase. But, of course, laborers as a group may not gain in a period of falling prices as many persons are usually unemployed during such a time.

Why is it that wage movements lag behind the movements of commodity prices in a period of rising prices? There are

several factors that may be noted by way of answering this question. In the first place, what may be called a reserve supply of labor tends to prevent wages from rising as do other prices in a period of prosperity. When prices are rising employers are anxious to extend the scale of their operations. This leads to increased bidding for materials and for money funds, and tends to still further raise the level of prices. The increase in the scale of business operations also leads to a demand for more laborers, but there is normally a reserve supply of labor that makes it possible for employers to get more labor service without increasing the rate of wages. The offer of increased opportunities for employment may result, first, in securing the services of persons who are unemployed or employed for only part time. Second, the laborers already employed may work "overtime" and thus reduce the demand for additional laborers. Third, if wage rates are later raised somewhat, this may call into employment many persons who at the lower rates did not wish to go into industry. Women engaged at housekeeping may thus appreciably increase the number of laborers. Thus the possibility of increasing the number of workers and the length of the working day operates to prevent wages from being increased as much during a period of rising prices as they would be if all persons were fully employed at the time that prices began to rise. For, such a condition of employment would mean that particular employers could get additional labor service only by bidding laborers away from other employers.

In the second place, after the reserve supply of labor has been given employment, the further rise of prices will tend to cause certain employers to raise their wage rates in order to attract laborers away from other employers, just as they bid up the prices of materials and the interest rate on money funds in order to get what they need in a market that is not adequate to supply all. In the case of labor, however, there is usually an attempt made by the employers of any city or industrial district to curtail bidding against each other. There are many devices by which this is accomplished. An employer who pays unduly high wages is looked at askance by his fellow employers. He is re-

garded as an unworthy member of the employer group because he is "spoiling the labor market." But employers often go further than simply subjecting recalcitrant members to a feeling of social displeasure. They may, for example, mutually agree that no one is to employ a person who is already at work for one of the other members. Any restriction of this sort necessarily operates to prevent wages from rising as rapidly as they otherwise would.

In the third place, the employers of one district through the control of advertisements in local papers, may prevent the employers in other districts from enticing away their laborers or forcing them to pay more in order to hold them. Then too, of course, the fact that labor is on the whole very immobile tends to prevent laborers from effectively playing off the employers of one district against the employers of other districts.

In the fourth place, laborers are not skilled bargainers. Their knowledge of general industrial conditions, and of what employers can afford to pay is usually very meager. In contrast to this, the person who is selling raw material to a manufacturer is normally as skilled a bargainer as is the manufacturer. Further, a raw material dealer can force the employers of one district to compete against the employers of another district, since he may ship his products to one as easily as to the other. Moreover, if he does not sell a given quantity of material on one day, he will have it on hand to dispose of the following day, while failure to sell one's labor for one day does not leave that service to be disposed of later.

A fifth element in this matter is that the contract with laborers usually runs for an indefinite time, save in certain union shops, and even there the contracts are normally for a period of one or more years. As a result of this, laborers are not constantly confronted with opportunities to increase the wage rates. Sellers of material, however, quote prices day by day, and, thus, as prices rise, and as the competition of buyers becomes more keen, sellers of raw material may take advantage of the opportunity to increase the quoted prices.

This analysis applies especially to periods in which prices

rise rapidly. It is less true of periods in which prices are rising slowly, but it is applicable even then.

In a period of falling prices, as has already been indicated, wages change much less rapidly than do commodity prices. The most important reason for this is the fact which has been discussed above, that laborers hold very tenaciously to wage scales to which they have become accustomed. A second influence which operates to maintain wages is a feeling on the part of some employers that a certain rate of wages is right and proper and that a lower wage would not permit workers to live as they should. Further, certain employers may reach the conclusion that wage cuts will incur the ill will of employees, foster strikes and thus carry still farther the disorganization of industry, which we may assume has already resulted if prices are falling rapidly. And, as a corollary to this, far-sighted employers may see in the stabilization of wages at the prevailing level a means of promoting a sufficient demand for goods on the part of laborers to check the fall in commodity prices, and thus promote prosperous business conditions. Such employers may occupy a dominant position among their fellows and, accordingly, may influence them to accept the prevailing rate of wages. While there are, of course, exceptional cases, most employers are anxious to conform to the group judgment of their fellow employers. And this, to repeat, may be in favor of a liberal wage policy.

The Wage Policies of Certain Employers. — Some employers do not follow a policy of hard bargaining with their employees. Many of them are undoubtedly genuinely unselfish in this. Others may reason that since better service will be given by employees if they believe themselves to be well treated, a liberal wage may give the employer more service for his money than would a low wage. Liberality in wage policy is indicated not only by paying high wages, but also by increasing wages with length of service, by giving holidays and vacations with pay, by retaining employees when the plant is not running to full capacity, and by voluntarily adjusting wages to an increase in the cost of living.

In addition to contributing to the morale of employees, a liberal wage policy may lower the wage cost of an employer in another way. Such a policy, especially if the rate paid is high, tends to attract to a given employer a large number of applicants and this permits him to select those that are especially capable. As a result, the wage expense to the firm may be considerably less than if lower wages were paid. This has long been the policy followed by the Ford Motor Company.

Some employers as indicated in the preceding section follow a labor policy that is far less commendable than the ones to which reference has just been made. Through agreements and understandings with one another, employers in one district may greatly curtail competition with each other to the disadvantage of the laborer.

Trade Unionism and Wages. — In order that they may secure higher wages than would otherwise be possible, and also for other reasons, many labor groups organize themselves into unions, as was developed in a preceding chapter. The union is effective in raising wages, or in preventing given rates from being lowered, for several reasons. First, competitive bidding among the members tends to be reduced, or eliminated. Definite rates are agreed upon by the union and each member pledges himself not to accept work below such rates. Anyone who does so, whether within the union or not, is held in great contempt by the union members and their sympathizers. He is a "scab." Such an attitude very obviously reduces competitive bidding. This may mean that persons who prefer to work at a given task cannot find employment in it, because at the given rates employers may not be able to extend their scale of operations, since to do so would mean an enlargement of output and a consequent lowering of price below the point that permits profits to be made at the present rate of wages. That is, what happens in such a case is that the supply of laborers who work at such a task is less than it would otherwise be, and the wage is correspondingly higher.

Such a result may also be accomplished by maintaining a closed union, that is, by not admitting all applicants to member-

ship. But this method of restricting the supply of workers in a given group is not commonly practiced, as it usually cannot be made effective, since in most cases, excluded applicants cannot be prevented by the union from working at the trade in question. But whether by exclusion or by obtaining common consent as to the justness of a given wage, the union is effective in raising wages if it can reduce the supply in a given line of work below the point that would otherwise prevail.

The union organization may also be effective in other ways in securing high wages for the members of the union. Through organization, laborers tend to become wage-conscious; they become interested in getting more; they come to have the point of view of the business man. As a result they press for wage increases and resist wage cuts. Further, the union organization is able to employ skilled bargainers to represent the members in dealing with the employers. Such men being anxious to retain their positions are usually alert to every opportunity to advance wages. The union leaders may also be able at times to suggest to the employers means of so increasing the efficiency of the industry that an increase in wages is made possible. Then, too, the union organization by means of the strike — by all the members quitting work — may be able to get a wage rate that could not otherwise be secured.

The union organization is not only able thus to influence the rate of wages for the group concerned, but is also able to affect favorably other aspects of the wage contract. The number of hours of work per day, or per week, and the general conditions under which work is carried on are normally specified in the bargain which the union makes with the employer.

There is another way in which the trade unions may have a very appreciable effect upon wage payments considered as a whole. The force of competition among employers tends to result, as was emphasized in the preceding chapter, in equalizing wages in different establishments and among different employers. This tendency, however, may not actually be realized. The degree of efficiency achieved by different plants and the wages paid therein may continue to be very different in dif-

ferent establishments. Data compiled by the United States Bureau of Labor Statistics shows that this is the case. A recent investigation shows that in the manufacture of common brick, one plant had an output of 17,730 bricks per man-hour while another plant had an output of only 3930 bricks per man-hour.[1]

Similar data for other industries show marked differences in different plants. One reason that differences in efficiency can be so marked is that the less efficiently conducted plants pay very low wages. Trade unionism tends to make it impossible for such conditions to prevail. They normally insist that the same wage rates shall be paid by different employers. This is known as the "common rule." Where this policy is applied, the wage rates in the least efficient plants obviously become equal to the wage rates in the most efficiently conducted establishments. The result of this is that the plants that are not conducted efficiently are thus put under pressure to make their establishments efficient. This policy of the trade unionists is undoubtedly far more effective than is the general force of competition in forcing the employers whose shops are inefficient to adopt the most approved methods of production.

The power of the union in the wage bargain, although it is considerable, is effective only within rather narrow limits. That is, the union is not normally able to get a scale of wages that is much above the rate that would otherwise prevail. The limitation upon the ability of employers to pay, and the inclination of laborers outside the union to work for less than union rates rather than accept still lower wages elsewhere, tend to keep the wage rate for any grade of union labor somewhere near the rate that would be set in the absence of the union.

Minimum Wage Legislation. In Chapter XLIII it was pointed out that some fifteen of our states have followed the precedent of England and Australia in enacting legislation which provides for the determination by a public authority of the minimum wage rates that employers may pay in specified fields. These laws have been applicable in practically every case only to

[1] Bulletin No. 439, p. 535.

the wages of women. It was also noted, in the chapter referred to, that these laws have been made ineffective by the conclusion of the United States Supreme Court that such laws are contrary to the United States Constitution. The one exception to this is found in the legislation of Massachusetts. The law in that state is not compulsory and hence "property is not taken without due process of law."

The fact that compulsory minimum wage legislation is now under the judicial ban in the United States does not, of course, dispose of the question. The merit of such legislation is still a matter of great importance. One of the arguments that was early advanced in regard to legislation of this sort was to the effect that the requirement of a certain minimum wage would result in unemployment. It was argued that since the play of the competitive forces results in marginal employers' paying as high wages as they can pay, the insistence that wage rates must be raised would necessarily result in unemployment. At first thought this argument appears to have great validity.

Certainly, if the forces of competition have in any instance led the marginal employers to pay all that they can afford to pay for a given grade of labor, then the wage rate cannot be raised without throwing at least some of the laborers concerned out of work. But under the operation of these laws, both here and abroad, unemployment has not resulted as wages have been raised. There are several conditions that may account for this. First, the lack of competitive bidding among employers and the failure of the employees to demand higher wages, may keep wages below the point that employers could easily afford to pay. Second, the low wages paid may be all that marginal employers can pay, or all that each employer can pay for his full quota of employees, in view of the efficiency of the employees; but an increase in the wage may increase the efficiency of the employees. By permitting them to live better — to have better food, clothing, and living quarters — the increased wage may so augment their efficiency that they are worth more to the employer. And in the third place, the higher wage set by legal authority may stimulate the employer to study his

methods of operation, and so improve the conditions of work that the employees will be able to produce more than formerly.

It has also been argued in respect to minimum wage legislation that the minimum rate specified by law would come to be the maximum rate paid by the various employers. The experience of the states where such laws have been in force for a considerable period of years shows that this argument is not valid. The minimum rates in such states have not become the maximum ones.

But as in the case of trade unions, minimum wage regulations are operative only within certain limits. Wages for any group cannot rise much above the wages received for similar groups and the laboring class as a whole is strictly limited in wages by the total economic output of the society. Clearly a legal provision to the effect that no employer could pay less than, say, five dollars per day, could not be maintained. American industry at its present state of efficiency does not at all warrant such a wage payment. The minimum wage laws have been successful in their application in the United States because of the restraint of the boards in prescribing wages. The rates for the most part have been those that the best employers were already paying, and thus those that the industry could afford to pay. Indeed the general results which have attended these laws in the United States make it very regrettable that the United States Supreme Court has seen fit to hold that such legislation is contrary to the United States Constitution.

One argument is frequently used by the proponents of minimum wage legislation to which attention should be called. It is frequently argued that the industries that pay very low rates of wages are parasitic and therefore should be exterminated. The contention is that since such industries do not pay a living wage the workers therein must receive support from other industries. This support is received by these low paid workers through the contributions of members of their families who are engaged in other industries. Hence the charge is that the industries paying low wages are parasitic and should be forced out

of existence through a legal requirement that wages should be raised. This argument is not valid.

Clearly it is in the social interest to have the inefficient industries displaced by more efficient ones. If the requirement that a living wage shall be paid will result in causing labor and materials to be transferred from less efficient to more efficient industries, a social gain will have been made. Such a transfer of labor and materials is that which the forces of competition are always tending to bring about. But this analysis, it should be noted, is in terms of less efficient and more efficient industries. It is not to the effect that an industry that does not pay what is regarded as a living wage should because of this fact be exterminated. If there is a group of laborers who cannot earn enough to provide support for themselves, it is certainly in the social interest that they be permitted to earn what they can. An industry that would make it possible for them to do this could not properly be regarded as subversive of the social interest. It could not properly be called a parasitic industry — meaning by that term one that should not be permitted to exist.

Wage Adjustments to American Standards of Living. — In the case of wage disputes, especially when they become serious enough to attract public attention, as in the case of strikes, a great deal is usually said about the advisability of a "living wage." Public arbitration boards that are provided in such cases often accept the "living wage" principle and insist that the employers pay a wage that will permit an American standard of living. This means that the industry in question is asked to pay a wage comparable to the rates that are paid by other industries. For, what is meant as an American standard of living is merely the customary standard — the standard that the prevailing rate of wages makes possible. Since the competitive forces — among employers and among employees — tend to bring about a uniform rate, such a public decree means that the rate is set that the play of economic forces is tending to establish. The action of the board speeds up the evolutionary forces.

Such a wage would normally be above the capacity of certain

employers to pay, and as a result some employees would have to seek work elsewhere. This would mean that the low wages had been due to the overcrowding of this industry as compared with other industries; that the total output in this line of work was such that the price of the product was necessarily low as compared with the prices of other products. Hence employers could not pay normal wages. The competitive forces, as stated above, would tend to correct this situation by the transference of some of the business firms and employees to other lines of work. To insist then that the industry in question pay a living wage is to hasten the establishment of that condition which competitive forces are tending to bring about.

This analysis in terms of tendencies calls for a word of caution. A government policy is not to be justified because it is in line with a tendency. The things that tend to come about are not necessarily desirable. Indeed, the tendencies of life are many. While there is a tendency for unusually low wages in one line of work to be raised, there is also a tendency for them to persist. If this were not true, interference by minimum wage boards or by boards of arbitration, in case of a strike, would not be necessary. Hence, such interference is in opposition to one tendency albeit it is in line with another.

The competitive tendency in relation to government regulation has been emphasized first, to point out the fact that such wage adjustments are in line with the operation of competitive forces, and, second, that since this is true, it must follow that the higher wages can be paid.

Free Income. In all modern communities the wages of laborers are supplemented by what may properly be called free income. This includes forms of economic income that are furnished without charge, or at but little cost, to the poorer groups. Public school education, free parks, libraries, roadways, and other forms of economic service that are provided by the state, constitute free income to those who contribute nothing or but little in the form of taxation. Various forms of social insurance, the cost of which does not fall entirely upon the persons who benefit therefrom, are also to be included in this

category. The amount of free income to the persons in the lower economic divisions has been considerably extended during the past few decades. In terms of real wages, this amounts to a very considerable gain to the wage-earning groups.

The Control of Wages. The fundamental principle in regard to the establishment of wages may be expressed in terms of supply and demand, as was done in the preceding chapter. On the basis of this principle it is frequently asserted that wages are not subject to control. It is argued that the law of supply and demand must not be interfered with by legislative control nor by forms of control exercised by the two parties to the wage contract. It will be appreciated that this is part of the idea that has been referred to in previous chapters to the effect that economic laws are natural laws and are therefore sacrosanct. This position, as previously noted, is invalid. Economic laws are subject to control. Certainly so far as the wage bargain is concerned, most of the topics which have been discussed in this chapter have to do with the control of wages. The formation of an employers' association amounts to an attempt to control the demand side of the labor market. Similarly, the aim of the trade union is to exercise control over the supply side of the market. Such control on the part of either employers or employees does not mean that the law of supply and demand is discarded. It merely means that a wage is set that would not have been set if the demand or the supply had not been consciously controlled. Similarly, minimum wage legislation is a form of control. Wage earners especially need to appreciate the importance of control over the wage bargain in order that they may secure for themselves as much as it is possible for them to get as a result of the wage bargain, and from the point of view of citizenship it is desirable that the possibilities, and also the limits, of control over this aspect of our economic life shall be appreciated. This is in line with the point that has been made at several places in the preceding chapters to the effect that one of the major problems in citizenship is that of controlling the economic forces to the end that the society shall be made to correspond as far as possible to the ideal.

PROBLEMS AND EXERCISES

183. Account for the fact that the gain in efficiency in the production of rubber tires and automobiles is so much in excess of that which has taken place in the boot and shoe industry during the past twenty-five years.

184. *a.* In Chart XIV explain the difference between the curves, wages per hour and full time wages per week.

b. The curve at the bottom of Chart XIV is in line with conclusions made in an earlier chapter. Explain.

185. Interpret the chart in connection with the point made in this chapter relative to the effect of a rising price level on real wages. The same for a falling price level. Refer to preceding chapters for data regarding the changes in price level during this period. Give original illustrations of the points made relative to the stability of wages as compared with prices.

186. Explain the wage policies of employers as you have observed them.

187. Are there any social disadvantages to the "common rule" device of trade unions (that all workers be paid the same rate)?

188. What was the case in which the United States Supreme Court held minimum wage legislation invalid? See Chapter XLIII.

189. What is meant by a living wage?

190. Indicate forms of free income other than those that are mentioned in the text.

191. "The law of supply and demand cannot be repealed by statute." What is the implication of this statement? Discuss the validity of the statement.

REFERENCES

The Bureau of Labor Statistics of the United States Department of Labor issues current material dealing with the various phases of the wage bargain. *Control of Wages*, by W. H. Hamilton and S. May, considers in detail many possibilities of control over wages by the laborers. *Wages and Capital*, by F. W. Taussig, is an outstanding work in this field. The many books listed in the appendix contain a discussion of this subject.

CHAPTER LIII

INTEREST

The Nature of Interest. — The paying of interest is a common phenomenon. One person borrows money from another and pays back not only the sum borrowed, but an additional amount as interest. Interest also appears in the granting of credit, and in the pricing of goods, as will be developed presently, but the dominant case of interest is in the loaning of money. Interest is always expressed in terms of a percentage of the sum loaned, and, unless otherwise specified, on the basis of a loan for one year. Thus interest at 6 per cent means that the charge for borrowing one hundred dollars for one year is six dollars.

It is reasonable to believe that in the economic development of men, the loaning of money followed very closely upon the beginning of its use. Nothing seems more logical than that, with money available, some persons should wish to borrow from others. And the reluctance to give without getting, as well as the competing demands of borrowers, may be expected to have very early led to a charge for such loans. The interest bargain is indeed as natural in the economic life of men as is the wage bargain. Both, of course, depend upon the private ownership of property and the existence of exchange relations. Also, both depend, as does all exchange, upon the existence of differences among men in regard to their circumstances, desires, or abilities.

The Prevalence of Loans. — The extent to which borrowing and lending take place to-day is almost incredible. The typical business firm is a heavy borrower. It has outstanding bonds which represent money borrowed from the general public and it owes notes at the bank for money borrowed there and, indeed, issues of stock are often in effect devices for borrowing money. While caution must be exercised not to become too heavily in-

volved in debt, most firms tend to borrow up to the margin of safety. Likewise the man who is in business for himself tends to borrow all that is safe for him to undertake to pay. Indeed, to borrow money at one rate of interest and make a higher rate in using it is the principal road to fortune, and the shrewd business man is not unaware of this. On the other hand, large numbers of persons are lenders. Professional men and employees do not have opportunity to use their money in business. If they are not to spend all that they get, they must loan to those who are in business. Further, of course, banks are special lending agents. They reloan the money which they borrow from cash depositors, and also, on the basis of their credit, they loan large sums of money in the form of checking accounts.

Borrowing and lending are so much a part of the fabric of our present day economic life that it is hard for us to realize that the words of Polonius to Laertes, "Neither a borrower nor a lender be," were words of wisdom in Shakespeare's time. The point is, of course, that the large scale enterprise of to-day is dependent upon borrowing and lending. For, since the large establishment involves a concentration of control in the hands of a relatively few men, (1) it is necessary for a few to borrow, or for the corporation to borrow, in order to get enough money to conduct the large enterprise, and (2) it is necessary for many persons to lend as the opportunities for using small sums of money in small scale enterprises are greatly reduced as a result of large scale industry. In short, an increase in the number of employees — a reduction in the number of independent business men — leads inevitably to an increase in the amount of lending and a reduction in the extent to which money is employed by the owners thereof. Thus it has come about that it is no longer true, to continue the quotation from Shakespeare, that

> ". . . loan oft loses both itself and friend
> And borrowing dulls the edge of husbandry."

In this day, loans are not only impersonal but are normally safe and a source of income, and, also, borrowing sharpens and extends the edge of business enterprise.

Interest Payments and Prices. — The extensive borrowing of

money has made the item of interest an important fact in our economic life. There are indeed but few exchange relations that do not involve a rate of interest. Or, to state this differently, almost all prices have within them an element of interest. A person who goes into business and borrows money must, of course, pay interest to the lender, and to the extent that he uses his own money, he forgoes the interest which he might receive if he loaned his money to others. Thus if a business man is not to lose money, or in case he is a heavy borrower, if he is to stay out of bankruptcy, he must set such prices upon the goods or services that he sells that he can recover the interest charge on the money which he employs.

There are, however, marked differences among industries in respect to the relative importance of the interest charge in the prices of the products. Suppose, for example, that a corporation should be formed for the purpose of buying land and setting out trees with a view to selling the full grown trees as lumber, some thirty or forty years later. The expenses in such a case would be made up almost exclusively of the interest charge upon the money invested at the beginning of this period. The price received for the lumber must be sufficient to cover the interest charge and other expenses if the corporation is not to lose money. And, normally, such prices could be set. Competition in this line of production would tend not to force price below such a point, nor permit it to rise much above it. Price in such a case would thus tend to be approximately a sum that corresponds to the interest involved.

In the business of house painting, to cite another extreme case, the interest charge is a very minor item. The amount that is invested in ladders and brushes would yield, if loaned on the market, only a few dollars per year in interest, and the money spent for paint and paid out as wages would yield but little interest during the time that intervenes between such outgo and the receipt of payment for work done. Thus the prices which the competitive forces tend to set for house painting contain only an insignificant item for interest. The principal charges are for wages and materials.

Most lines of enterprise lie between these two extremes. But of course, in so far as industries use extensive equipment the interest item is of considerable importance. Modern industry differs markedly from that of preceding times in this respect. In the manufacture of steel, for example, it is said to be necessary to make an investment of $10,000,000 in plant and equipment before beginning operations. This means that the interest item is a large factor in the price of steel, and, incidentally, it means that the management need be less concerned in regard to the wages paid to labor, than if the fixed investment were relatively less.

In the field of merchandising, a great deal of attention is given to the interest factor in the cost of conducting business. This takes the form of concern in regard to the turnover of stock. If, for example, a merchant sells his entire stock on an average of twelve times per year, the expense in interest for each article sold will be only one-twelfth as much as if such a quantity of merchandise were sold upon an average only once per year. An increase in the rate of turnover thus reduces the importance of the interest item in the price of retail goods.

Care must be taken not to assume a wrong relationship between interest and price. Costs do not give value. One may pay wages and interest and other costs and produce a product that cannot possibly be sold for enough to defray expenses: But in this way bankruptcy lies. To succeed in business, costs must be met in the prices that buyers will pay. This is accomplished in any line of production by keeping the supply at a point that will permit a price high enough to meet the costs that are involved. Or stated differently, competitive activity in any line of business tends to be checked at a point that will permit the total output to be sold at a price that will equal cost. Interest is thus a factor in the determination of price by causing business men to restrict production in the various lines of enterprise to a point that will permit the receipt of interest.

Credit Sales. — Interest also appears as a special item in the prices of goods that are bought on credit. This is very apparent in transactions among business men, as a discount is almost in-

variably given for cash payments. The business man who has borrowed at the bank can save interest by prompt payment, and so can make a better price to his customers if payment is to be made at once. Or even if he has not borrowed, since he could loan money at interest, or use it profitably in his business, he can afford to sell at a lower price for cash than for future payment. Hence, a retail merchant must, in order to make enough money to permit him to stay in business, charge higher prices for his goods if he sells on credit than would be necessary if he sold for cash. Another statement of this is that if all persons were to pay cash for their purchases, the cost of merchandising would be reduced, and competition among merchants would lead to a lowering of price. There is another item in the case of sales on credit, and also in most loans, that is closely related to the interest charge; namely, the risk of loss from non-payment for goods that are sold on credit. This will be considered presently.

The Price of Income-yielding Property. — Another case of interest is found in the selling price of certain types of property that yield a series of incomes. A parcel of land, for example, that yields $400 net income each year, and is expected to continue to yield this sum, will be worth about $8000. This figure is derived by a process known as capitalization, which has been described in the chapters on price. The expected yearly incomes are discounted to find their present worth. This is a sum of money which, at the rate of interest which is yielded by property whose income is equally certain, would return an annual sum equal to the income in question. Thus $8000 at 5 per cent would give $400 income per year. With this rate of interest prevailing in the market for investments of a similar character, the forces of competition would not permit the price of this land to vary appreciably from $8000. The rate of interest is thus an indispensable item in arriving at the selling price of such property.

Varying Rates of Interest. — As already suggested, there are many different rates of interest at any one time. United States Government bonds may sell for such a price that less than 4 per

cent income will be received by purchasers, and at the same time certain industrial bonds will be selling to net 5 per cent and others to net 9 per cent or more. And in the daily financial statements of the metropolitan banks perhaps six or seven different rates of interest are quoted for various kinds of commercial paper. These differences are to be accounted for largely on the basis of the varying degrees of certainty as to the possibility of receiving payment. That is, the rates of interest in the different fields tend to vary according to the risk of loss.

There is another item that is important in the case of banks and other lending institutions; namely, the expense of conducting the business of making loans. Banks, for example, borrow money at one rate of interest and loan it at another. Clearly, if they are to meet the expenses of carrying on their business, the one rate must be less than the other. Perhaps, also, the matter of risk is a factor in making these two rates different, as depositors in banks may be subject to less risk of loss than are the banks in making loans.

Gross Interest and Net Interest. — Economists often use the terms *gross interest* and *net interest* in discussing the varying rates of interest. *Net interest* means the rate that is paid for loans that are regarded as not involving any risk of loss, and that do not involve any expense to the lender. The term *pure interest* is sometimes used synonymously with *net interest.* The two concepts, *gross* and *net* interest, are very important in the study of interest. But it is with gross interest — the rates actually paid — that we are mainly concerned.

The net rate is sometimes said to be the price that is paid for *abstinence*, that is, the price paid to induce lenders to *abstain* from using the money themselves. Similarly, certain writers speak of it as a price paid for *waiting;* the idea being that lenders must wait until the money is returned to them before they may spend it. The net rate of interest is also sometimes said to be the price paid for *savings*, or the price paid to induce persons to save. But perhaps it is best to speak of interest merely as payment for a loan of money. This seems to indicate

more clearly the nature of the transaction than do the other terms.

Despite the fact that there are many different rates of interest at any one time, the term *rate of interest* will be used frequently in the following discussion. But while one rate may, for ease of expression, be taken to be typical of all, it must not be forgotten that there are many interest rates.

The Rate of Interest and the Supply of Money. — To define the rate of interest as the price paid for a loan of money, suggests that the rate may vary with the amount of money that a community or a country possesses. It might seem that the larger the supply of money, the more there would be available for loans, and thus the lower the rate of interest. But as David Hume pointed out almost three hundred years ago, this is not true. Prices are adjusted to the supply of money, as has been developed in an earlier chapter. If there is but little money, prices are low, while if the supply of money is abundant they are high. With high prices, more money is required to accomplish given purposes, than if prices are low. Thus the demands of borrowers are increased as the supply of money increases, and this prevents the rate of interest from falling as the amount of money is increased.

Assume a situation in which there is a certain quantity of money and a given level of prices. Assume, further, that the quantity of money is doubled and that all prices become twice what they were before. Lenders of money will now have twice as much money to lend as in the first case, but borrowers will need twice as much as formerly, and thus with both the supply of money loan funds and the demand for loans doubled, the price paid, or the rate of interest, will tend to be the same as before the change in the supply of money took place.

The second of these assumptions is somewhat far-fetched. To double money would not exactly double all prices, and thus varying quantities of money may result in different rates of interest. But, in general, the relationship is as indicated. Or, however imperfect the balance that results from a change in the

supply of money, the rate of interest clearly does not vary directly with the amount of money.

This analysis, it should be noted, is in terms of an increase in the quantity of money after sufficient time has elapsed to permit the resulting price changes to be made. But while the supply of money is increasing, while prices are rising, the rate of interest will be affected, as will be noted later.

The Demand for Loan Funds. — Since a rate of interest is a price paid for money loans it is necessary to analyze the demand for and the supply of loan funds in order to understand the determination of the rates of interest. The demand for loans may be divided into three parts, the (1) demand of business men, the demand of (2) consumers, and the demand of (3) the government.

The Demand of Business Men. — The chief demand for loan funds comes from business men. The persons who are shrewd in the affairs of business are able to pay a higher rate for the money of the less shrewd than such persons could make if they themselves used their money. Such differences in business ability lead to the making of loans. Also, differences in inclination to venture money on enterprises prompt some persons to loan and others to borrow. And, the fact that some persons have better opportunities to employ funds than do other persons, makes borrowers of some and lenders of others.

The general demand of business men for loan funds tends to vary with the opportunities that are available for the use of industrial equipment. That is, as men believe it to be profitable to construct railroads, build factories, install machinery, and otherwise make use of equipment, the demand for loans is correspondingly increased. It follows from this, of course, that any new development that calls for either new or additional equipment will augment the demand for loans.

Thus if an engineer devises a new type of machine that makes it advisable to discard the machinery that is still in good repair, or if consumers' demands are increased for goods such as automobiles, radio sets, and electric washing machines, the demands of business men for funds with which to procure equipment and

undertake these lines of production will be increased. Likewise, any shift in consumers' demand from goods requiring one type of equipment for their production to others that require different equipment, as from carriages to automobiles, augments the demand for loan funds.

On the other hand, of course, if improvements should cease to be made in industrial processes, equipment would not become obsolete until it was worn out and the demand for funds for the equipping of factories would be less than under conditions of changes in the character of equipment. Likewise, a lack of change in consumers' demands would keep the demand for loan funds below what it would be if frequent changes made new equipment necessary.

These considerations suggest, of course, that the great industrial developments of the past thirty years have been a factor of considerable importance in making the rate of interest relatively high during this period. In the early nineties the rate was very low. Many careful observers at that time believed that the resources of the country had been so developed that high rates would not again be experienced. The president of the New York State Bankers' Association, for example, said in his annual address in 1898, "The days of 6 per cent interest are gone, only to return at troubled intervals when normal conditions are disturbed. The choicest investments yield less than 3 per cent. Some railroad bonds commanding 3½ per cent command a premium. Rentals are proportionally reduced and these conditions have come to stay. The growing wealth of this country is enormous, and as a permanent condition we must recognize four per cent as a good return for investment."[1] But great industrial changes began in the late nineties and the rate of interest has since been uniformly high. The development of the automobile, the paving of roads, the extension of public utilities, the construction of office buildings, the building of residences and the supplying of modern equipment for them

[1] Quoted by David Friday, "The Probable Trend of Interest Rates," *Annals of the American Academy of Political and Social Science,* Vol. XCVII, Sept., 1921, p. 31.

have all led to extensive borrowing by the many firms that have in one way or another assisted in their production.

Another factor of importance in the demand of business men for loans is the terms upon which they sell their products. If they sell for cash they can pay off their loans, or reduce them, whereas if they sell on credit, they, in effect, become lenders to the purchasers and so are unable to discharge the obligations that they have assumed. The extensive installment buying of the past few years has thus contributed to the demand for loan funds, as has the long prevailing practice of retail purchase on 30 days' time.

A very important source of demand for business loans comes from the less well developed regions of the earth. Firms wishing to develop the resources of so-called backward countries normally borrow heavily from persons living in countries where modern business has long been established. Thus the people of England are estimated to have invested yearly as much money abroad in the period preceding the World War as they invested at home. In other words, foreign business firms, or English firms in business abroad, borrowed as much money from English people as did the firms whose business was conducted in England. And, especially since the World War, an important portion of the borrowing in our market has been that of foreign firms.

Another important general factor that conditions the demand of business men for loans is the security of property. If property rights are not secure, if contracts cannot be enforced, if governments may confiscate goods or levy onerous taxes, the demands that business men would otherwise make for loans will be curtailed. This point has been strikingly emphasized whenever a great power has taken over the government of a region that has been marked by frequent rebellions and uprisings. Such a change in government invariably stimulates investment in the given region, or in other words, increases the demand for loan funds.

The demand of business men for loans may also be greatly affected if changes are taking place in the general level of prices.

If prices are rising, business men are anxious to order materials and equipment at an early date rather than at the time that they would otherwise order them. They thus wish to borrow for this purpose. Further, rising prices mean an additional outlay for materials and other purchases, even aside from purchasing in anticipation of future needs, and this increases the demand for money funds. Then, too, rising prices tend to increase the profits to be made in business, and this makes business men desirous of enlarging their plants and extending the scale of their operations. This, also, of course, increases their demand for loans. Rising prices thus tend to bring about an increase in the rate of interest.

Falling prices tend to have just the opposite effect upon the demand for loans. Business men usually wish to curtail production during such a period; outlays for materials and equipment are reduced even apart from the curtailment of production; and purchases are delayed as long as possible. The falling off in demand at such a time necessarily leads to a lowering of the rate of interest. This is more especially true if prices are falling rapidly, than if the downward movement is very gradual. Under the second condition, increased efficiencies in business may so increase profits, in spite of a falling price level, that the demand for funds is maintained. This would prevent the rate of interest from falling. This is especially likely to be true if the falling price level results in large part at least from an increase in the efficiency in industry.

The Demand of Consumers. — The demands for loan funds on the part of persons who wish to purchase consumption goods may also be a factor of importance in the loan-funds market. An analysis of the demands of consumers for loans amounts to a consideration of the reasons as to why persons are willing to pay a premium in the form of interest in order to procure goods that they are not able to pay for at the time of purchase. One factor of importance here is the general economic condition of the community. If the country is prosperous, if the standard of living is rising, families are prompted to anticipate their increase in earnings, or at least their accumulation of savings, and

extend their scale of living by borrowing. The social pressure to live "better" and the feeling of assurance as to the ability to meet obligations both contribute to this. Accordingly, families borrow to buy, rather than postpone purchase until they have saved sufficient money to permit cash purchases to be made.

Consumption borrowing for the purchase of dwelling houses has long been a common practice, but has been greatly extended recently. A special financial institution, the building and loan association, has been developed to loan money for the building and purchase of homes, and within the past few years such associations have grown to tremendous proportions.

Installment buying and the general practice of purchase on credit has been referred to above as contributing to the demand of business men for loans. But such credit purchases of consumption goods are very closely related to consumption borrowing. As already noted, consumers in such cases pay interest on their unpaid bills in the prices that they pay. The borrowing in the loan market is by business men, but it is done, in effect, on behalf of consumers.

The Demands of Governments. — Another source of demand for loan funds is the borrowing by governments. In the United States there is a great deal of such borrowing. School districts, cities, the states, and the national government all borrow from time to time. This borrowing is usually for the purpose of erecting school buildings, paving roads or streets, purchasing parks, or providing funds for some other form of public works. Indeed, such additions to public property are seldom made by our state and local governments except with borrowed money. The national government borrows for such purposes very seldom, although in the case of the Panama Canal the necessary money funds were secured in that way. Such borrowing is done by selling bonds.

Governments also almost invariably borrow during the course of a war. There are two general methods by which governments borrow at such a time: one is by the sale of bonds and the other is by the issuance of paper money. But if a govern-

ment borrows by issuing paper money, this does not involve entrance into the loan market. Such borrowing is thus outside the problem which we are considering here. It is as borrowers through the sale of bonds, that governments contribute to the demand for loan funds and thus affect the rate of interest.

Demand for Loans and the Promise of the Future. — In the demand for loans by business men, by consumers, or by governments, the expectation in regard to the future is very important. This has been indicated in the above discussion, but is of such importance that it deserves additional emphasis. Business men borrow if they expect business to be good, or what amounts to the same thing, if they believe that they can install new equipment and make it more than pay for itself, or utilize new methods, or in any other way carry on production at a profit. And consumers are encouraged to borrow if the future promises to yield more than does the present. If wages are rising, or if with no change in wages, savings are possible, consumers' borrowing is increased, because of the expectation of ability to pay off the loans.

Thus if changes were not taking place, if new devices that lower costs to business men were not being invented, if new natural resources were not being discovered or new uses found for those already at hand, if capital production were not being made more efficient, if men and women were not prospering and as a result wishing to change their scale of living, there would be but little demand for loans. Likewise, government borrowing rests upon the anticipation that the community is going to prosper, that the amount of taxable property will increase, that the population will be augmented, and in the case of war, that the enemy will be defeated. If the opposite of these conditions are anticipated, people would not undertake the responsibility of paying back later money borrowed for public purposes. In short, if a society were unchanging, or as unchanging as a human society can be, there would be but little borrowing. The demand for loans comes very largely from the rosy promises of the future.

The Supply of Loan Funds. — There are two principal sources

of supply of funds in the loan market, namely, the savings of individuals and the extension of credit by banks. The savings of individuals will be considered first.

One factor that accounts for loans by individuals has already been indicated in the discussion above. It was there pointed out that differences in business ability, or in the degree of inclination toward the conduct of business enterprise, or differences in the opportunity to conduct a business, makes certain persons lenders and other persons borrowers. The supply of loan funds thus comes in part from the same conditions that bring about part of the demand for loans.

Further, the motives of those who save are very similar to the motives of those who borrow for the conduct of business. The one group borrows in order to make money, and the other group loans for the same reason. The lender and the business borrower are in a sense partners. The one supplies the necessary funds and the other undertakes the risk of conducting the enterprise. There is the same element of frugality in the conduct of each. They both save part of their money rather than use it all in the purchase of consumption goods. But while the savings of a business man are part of the total social savings they do not, if used directly in his business, augment the loan fund and thus help to determine the rate of interest.

It is in the field of consumptive borrowing by individuals that we find the sharpest contrast between borrowing and loaning. If one spends his money for consumption goods, he obviously cannot loan it, while if he loans it, he is thereby denied the opportunity of spending it. It is in thus deciding that money shall be saved and loaned at interest rather than used in the purchase of consumption goods that the loan funds that are supplied by individuals are brought into existence. This difference between spending and saving will be emphasized later.

The Supply of Loan Funds and Inequality in Wealth. — Economists have very frequently emphasized the point that marked inequalities in wealth tend to augment the supply of loan funds. The idea is that more money will be saved if some persons are very rich and others poor, than if the volume of

wealth is more evenly distributed. The point is, of course, that it is much easier to save something out of a large income than out of a small one. Indeed, one's income may be so large, as in certain cases to-day, that much more difficulty would be experienced in spending all of it than in saving part of it.

But while marked inequality may thus augment the supply of loan funds it in no way follows that such a condition is desirable. Inequality is often defended on the ground that the large loan fund makes possible the building of equipment and the undertaking of expensive projects that are beneficial to the great mass of the people of the community. But to argue that most persons must be very poor in order that a few may be very rich and thus able to supply the loan funds which will make possible the industrial operations that are required for the production of the bare necessities of life for the poor, is to have a very pessimistic view of our economic system. The very rich, according to this argument, must grind down the faces of the poor in order that the poor may not perish utterly. This is verily the counsel of despair.

There is certainly nothing incompatible between approximate equality of income and the providing of loan funds with which business operations may be conducted. The demands for consumption goods under such conditions would afford profitable opportunities for the employment of loan funds, and they would undoubtedly be supplied. Indeed, the rate of interest would rise until, in view of the demand for consumption goods, the requisite supply of loan funds had been provided. The rate of interest would, of course, tend to be higher under such conditions, than when large sums are saved and loaned by the very rich with but little regard to the rate that prevails.

There is another important consideration in connection with this problem. If the incomes of the masses are very low, business men will not be anxious to borrow funds with which to produce goods for sale to the general public. This will cause the rate of interest to be low and the rich persons who have money to loan will be encouraged to invest it abroad. Since loans of money across national boundary lines lead to the export

of goods, the result is that the labor and natural resources of the one country are employed to produce goods, usually in the form of industrial equipment, that are used by the people of other countries. When such investments become so large that the interest income is in excess of new loans made abroad, the lending country may receive imports in excess of its exports, to the advantage of the general community. But at any one time the well-being of the one nation is reduced because of the profitable opportunities that are offered abroad to home lenders. A more equal distribution of income would increase the profitableness of investing funds at home.

To state this matter differently, ability to spend on the part of the general public is as vital to the building of equipment as is the ability of a portion of the community to save. Our mammoth factories have been constructed because the mass of the people are able to buy the products that are turned out, as well as because some persons have been able to save the money funds with which labor might be employed in factory construction. Indeed, with the same ability to save on the part of the few, but with a lack of ability on the part of the masses to buy, these loan funds would have been invested in other countries. The result of this would have been, as already indicated, that our labor and materials would have been used to produce goods for the use of people in other countries. That is, the ability of the very rich to save rather than proving to be beneficial to the poor, is to their immediate disadvantage if investments are made abroad.

The situation in England is illustrative of this. The marked inequalities in wealth there have made large accumulations of loan funds possible, but the inability of the great mass of the people to buy many goods has led to the making of very extensive loans abroad. This has meant that the working people of England have been producing industrial equipment and other goods to be used in other countries rather than at home. If income had been more equally distributed in England, the supply of loan funds might have been less, but the volume of business devoted to the production of goods for English people

would have tended to be considerably more. During the latter decades before the war, the volume of goods imported into England exceeded the volume of goods exported. This was in part due to the interest payments that were being made on the foreign loans of Englishmen. Thus the general population of England was then receiving a net gain from foreign investments. But during any one year, or decade, the foreign loans which the large incomes of a few make possible, are to the disadvantage of the general community.

Inequality of wealth cannot be defended in relation to the accumulation of loan funds. Not only may the savings of the masses be counted upon as being requisite for the carrying on of the production of the goods which they can buy, but large accumulations by a few rich persons tend to be to the immediate disadvantage of the masses, because of the foreign investments that are thereby encouraged.

The Savings of Business Men. — The amount of money that is saved and loaned does not constitute the total amount of a nation's savings. Considerable sums of money are saved by business men and employed directly in business. A very important part of such savings is made by corporations. As indicated in Chapter XIII, corporations usually follow a conservative dividend policy. They usually pay a nominal rate of return, from 4 to 6 per cent interest to the stockholders and retain in the business any earnings in excess of this amount. Countless illustrations of an increase in holdings or in the plant equipment of corporations through such savings could be cited. The Ford Motor Company is an example of the results of this practice. This mammoth plant has been constructed almost entirely out of the profits which have been earned and retained in the business. Such savings on the part of corporations are very significant in adding to the total amount of our savings. They do not, however, immediately affect the rate of interest which we are here considering, as they do not come into the money market in the form of loan funds.

Financial Middlemen. — There are many institutions that play the part of middlemen in the matter of loan funds. Banks,

building and loan associations and insurance companies are specially noteworthy in this connection. They collect from the general public large sums of money which they re-loan. Without such financial institutions, it would be almost impossible for the individual lender to make effective use of his money in the loan market.

The Rate of Interest and Supply of Funds. — It was noted above that the supply of loan funds grows out of the fact that individuals choose to save, rather than to spend, the money which is under their command. The rate of interest is highly significant in establishing the balance between saving and spending. A high rate of interest tends to encourage saving and discourage spending, while a low rate does not so effectively encourage saving and check spending. Not all persons, however, are influenced by the rate of interest in choosing between spending and saving. Some persons would save money regardless of the rate of interest. Indeed, this is the case in a limited way of anyone who is carrying any cash about with him. Such money is not yielding interest and yet has not been spent. In addition to the very large group of persons who would undoubtedly save something for the proverbial rainy day even if they received no interest, there are many persons who have such a great passion for accumulation that they would save very considerable sums of money even if they were to be charged a price for doing so. At the other end of the scale there are many persons who would perhaps not save anything however high the rate of interest might be. Such persons follow the rule: "Eat, drink and be merry for to-morrow we die."

It is reasonable to believe that between these extreme cases there are to be found persons of all degrees of desire relative to spending and saving. If this is true, any one rate of interest would tend to check somewhat the spending of certain persons by encouraging them to save.

This would mean that with the rate of interest as it is at any time, certain persons would be at the margin. Any alteration in the rate of interest would thus affect the volume of savings. A rise in the rate would transfer marginal spending to

marginal saving, and a fall in the rate would cause the marginal savers to become spenders.

The way in which the rate of interest tends to hold the balance between saving and spending may be further indicated by an illustration. Suppose that rather suddenly there is a marked increase in the desire to spend rather than to save. This would reduce the supply of loan funds and at the same time tend to raise the prices of consumption goods. As a result business men would tend to bid up the rate of interest. They would be more anxious than formerly to have loan funds and there would be less money available for borrowing. The rise in the rate of interest would encourage certain persons to curtail their purchases of goods and loan money. Thus a new balance would be struck between saving and spending at a rate of interest somewhat above the former point, but at a rate less than the one that was established as the immediate result of the increased demands of business men for funds.

On the other hand, suppose a marked decrease in the desire to spend as compared with the desire to save. This would mean that the amount of goods purchased would fall off and the supply of money offered to borrowers would increase. Both the reduction in the purchase of goods, and the increase in the supply of loan funds would tend to lower the rate of interest, — business men would be less anxious to borrow and there would be more funds available for them. This reduction in the rate of interest, however, would make certain persons less anxious to save than formerly and would thus increase their spending. This would tend to raise the prices of goods and stimulate the demand of business men for funds, at the same time that the supply of funds is reduced because of the increase in the amount of spending. Thus the fall in the rate of interest would tend to be checked, and a new equilibrium would be established between the spending and the saving of the community.

It is well to note that an increase in the rate of interest may influence certain persons to save less rather than more and *vice versa*. Thus if one is anxious to provide an income of $2000 per year for himself or his dependents he would need to save

$50,000 if the rate of interest were 4 per cent; but if the rate were 5 per cent $40,000 would yield the desired income. Hence a rise in the rate might cause one to curtail his savings, and a fall in the rate might prompt him to increase them. It does not, however, seem to be at all possible that such a case is typical. Similar reasoning in regard to the conduct of business men would lead to the conclusion that large profits would discourage and small profits encourage enterprise. There are undoubtedly cases in which this is true. Large profits make it possible for one to retire from business, while small profits, or losses, make continuous work necessary. But generally speaking, the larger the profits the more zealously business men apply themselves to their tasks; and similarly, it seems safe to conclude that the greater the reward in interest the larger will be the volume of savings.

There is another aspect to the effect of a varying interest rate upon the volume of savings. If the interest rate rises, the income of persons who have invested (or loaned) money tends to rise, except in the cases of long term loans at fixed rates of interest. Such increases in incomes make it possible for the former lenders to loan still larger sums without additional sacrifice. Also, of course, any deduction in interest earnings would curtail the ability of lenders to make further loans. There is thus this additional reason for expecting that the supply of loan funds tends to vary directly with the rate of interest.

This is, it may be observed, one of the many points in economics upon which it is difficult to get statistical data. We must accordingly base our conclusions upon general observations of human conduct.

The Rate of Interest and the Length of Life. — The balance between saving and spending, for the three or four centuries that cover the period of modern industry and its beginnings, has been such that the rate of interest has been in the neighborhood of 5 or 6 per cent per year during this time. Two or 3 per cent per year has been the lower limit and 8 or 10 per cent per year the upper limit. It is a very interesting question as to why the rate of interest has been normally confined to these limits.

Why hasn't the normal rate been $\frac{1}{2}$ per cent per year or 20 per cent, rather than about 5 or 6 per cent? Apparently all of the economists, with one exception, who have discussed the subject of interest, have not considered this question. They have made no attempt to determine why the supply and demand conditions have established the one rate rather than a very much higher or a very much lower rate. Professor Cassel, of Stockholm, raised this question some twenty-five years ago and answered it by saying that the normal length of life is responsible for the rate of interest being as it is.[1] His conclusion has apparently not been accepted by economists as his idea has not been repeated in subsequent books or articles. To the present writer, however, the idea seems to be sound, although the argument as presented by Cassel is not wholly acceptable.

It must be observed in the first place that the length of life controls the rate of interest only in a most general way, if at all. That is, the length of life cannot be considered as exerting any appreciable influence in making the rate of interest 5 per cent per year rather than 6 or 7; nor could any change which it seems possible to make in extending the number of years that persons of age 30 may be expected to live, appreciably alter the rate of interest. Although, if the following analysis is sound, any change in the number of years that persons of maturity may expect to live is a factor in the situation and tends to affect the rate of interest.

The argument in support of the point under discussion turns upon the relation between the length of life and the supply of loan funds at varying rates of interest.

The case can perhaps be best presented by assuming very unusual conditions in regard to the rate of interest and the length of life. Suppose that, due to unusual demands, the rate of interest should rise to 20 per cent. This would tend to greatly augment the amount of money saved. For example, at 20 per cent interest, one could by saving $100 per year for less than four years, reckoning interest quarterly as the money is saved, have a capital sum of $500, which would yield at

[1] *The Nature and the Necessity of Interest*, London, 1903.

this rate of interest $100 per year in perpetuity. Thus at age 25, for example, one could, by saving a fixed amount each year, have by age 30 an income for the remaining years of his life equal to the amount of the yearly savings. Since one who is in good health at 30 may reasonably count upon living to age 65 or 70, such savings would seem to be very desirable, as one could expect to enjoy the income for some forty years or more. And if the normal span of life were longer there would appear to be still more reason for saving money during the early years of the working life, if the rate of interest were very high.

But if life were much shorter than it is to-day, an unusually high rate of interest would not encourage saving as it does now. If age 35 were the maximum, as age 100 is now, there would certainly be much less reason to save money between the ages of 25 and 30, even if the rate of interest were 20 per cent, than there is to-day. Savings would, of course, be made under such conditions but the point is that the short period left for the enjoyment of income would lead many persons to spend money that they would otherwise save.

The conclusion then appears to be that very high rates would lead to great savings with the length of life as it is now, but that if life were much shorter, the high rate of interest would not have this effect. In other words, the conclusion appears to be that the present length of life would not permit the rate of interest to be as high as 20 per cent. If this conclusion is sound, then it follows that the length of life is a factor in inducing such a volume of saving relative to spending that the rate of interest does not normally rise above 8 or 9 per cent.

Let us now consider the case of a very low rate of interest. Suppose the rate to fall to ½ per cent per year. Savings would be greatly curtailed. Many persons would consider that it was not worth while to save at such a rate. Would this conclusion depend upon the normal length of life?

There is reason to believe that it would. At ½ per cent per year, one would have to save $240 per year for 70 years in order to have a yearly income of $100. And at 1 per cent interest, the length of time over which one would have to save $100 per

you would at least have

year in order to have an annual income of $100 per year would be 70 years, or far beyond the normal span of a working life. But if life were much longer than it is, accumulations at very low rates of interest would yield incomes sufficient to justify the saving.

If, for example, life were twelve times as long as it is now, saving, with the rate of interest at $\frac{1}{2}$ per cent per year, would not be unreasonable. The proof of this is found in the fact that measured in months our lives are twelve times as long as when measured in years, and the prevailing rate of interest is approximately $\frac{1}{2}$ per cent per month. Saving is encouraged at this rate per month, because there are so many months in the normal life in which to enjoy the income from the savings. But at this rate per year, life is too short to make it advisable to save for the purpose of securing an income.

The effect of the length of life upon the volume of savings at different rates of interest can also be shown by considering the purchase of income yielding property out of savings. Assume that a certain farm bears a net rent of $400 per year, and that a young farmer is considering a proposition that he buy it and pay for it with yearly payments of $800. A portion of each payment would be used to pay the year's interest on the unpaid balance, and the remainder would be used to reduce the principal. The $800 payment would mean that in addition to the $400 net rent which the farm will yield, it would be necessary for the buyer to save $400 yearly out of the additional income that he earns in the farming operations.

If the rate of interest is 5 per cent per year, the price of the farm will be $8000, and the young farmer could pay for it in 9 years. If the rate of interest were 10 per cent, the purchase price would be $4000, and at $800 per year the farm would be paid for in less than 5 years. At 20 per cent, the price would be $2000, and the farm could be fully paid for in $2\frac{1}{4}$ years on the terms suggested.

But, suppose the prevailing rate of interest were 2 per cent. The price of the farm would then be $20,000, and at $800 per year, the farm could not be paid for in less than 21 years. At

1 per cent interest, the price would be $40,000, and 41 years would be required to pay for it if an amount equal to twice the rental income were paid each year.

Clearly, the time required for a farmer to purchase such a farm out of his savings, when the rate of interest is high, is in the sharpest possible contrast to the time required when the rate is low. At the higher rates, the shortness of the time over which one need save in order to buy the farm, would encourage saving; but at a rate of, say, 1 per cent, the number of years over which savings would need to be made, with any reasonable payment per year, is so far in excess of the normal span of life that saving with a view to purchasing the farm is outside the bounds of possibility.

These illustrations show the spur to saving which would result from a very high rate of interest, and the check which would come from a very low rate. Further, they indicate that the saving period in the normal span of life is of commanding importance in encouraging saving in the one case and discouraging it in the other. The conclusion follows that the length of human life is a factor of great moment in determining the range within which the rate of interest fluctuates.

Bank Credit as Loan Funds. — As already indicated, banks play an important part in the money market by acting as middlemen between the individual lender and the business firm that borrows funds. They also have a very appreciable effect upon the loan market by augmenting the supply of loan funds through the utilization of their own credit. How this is done has already been explained in the chapters dealing with banking. It is sufficient at this place to indicate that a considerable portion of the loan funds of a community are based upon the credit of banks: that is, the banks not only loan money but also the rights to command money. These rights are used as if they were money and thus the supply of money media is increased. Obviously, the greater the development of the use of bank credit as money media, the greater the possible increase in the supply of loan funds.

Interest as a Share in Distribution. — From time immemorial

objections have been made to the receipt of interest as a source of income. Under the Mosaic law, Jews were prohibited from taking interest from each other, and similarly the Roman law forbade the payment of interest as between Roman citizens. Aristotle, a celebrated Greek philosopher, insisted that interest was inequitable, and for the first thirteen centuries of its existence the Christian Church was relentless in its opposition to the receipt of interest.

The difference between the attitude towards interest in these earlier times, and the attitude to-day, is to be explained largely by the difference in the purposes to which loans were devoted then as compared with now. To-day, as has been frequently emphasized, loans are largely for business purposes, but in the early times to which reference has been made, loans were very largely for consumption purposes. The principle of good fellowship and brotherly kindness made it seem improper to exact an interest payment for a loan of money. To-day, since the major part of the borrowing is done with a view to making money, it does not seem to be inequitable to charge a price for the funds loaned. But despite this condition, one occasionally hears protest against the receipt of interest as a source of income. Since interest is a payment merely for loaning money or owning income-bearing goods, the receipt of interest seems to be in conflict with the ideal that one should get only by giving. This phase of the matter is particularly evident when one does no work but because of a large income in the form of interest is able to live in opulence.

It is, indeed, regrettable that one should make no contribution to the economic society, and at the same time live off the fat of the land, at the expense of the producers of goods. If it should be argued that such a person makes a contribution by the expenditure of his money, the answer may be made that since in the event of the death of that person his money and property would be left to the control of others, expenditure by him cannot be regarded as a contribution. The simple test as to the effect of one's death on the society will determine whether one is or is not living at the expense of others. Clearly, in life

as in a racing boat one should pull his own weight. The receipt of interest permits one to play the part of a drone.

The remedy for such a condition is to be found in the development of a quickened sense of social responsibility and in a rather vigorous application of inheritance taxes, rather than in any limitation upon the receipt of interest. As part of the institution of private property, the making of loans and the employment of one's own funds in business are clearly of social value. Hence since one who possesses money may if he wishes, spend all of it, the payment of interest promotes the general welfare by inducing some persons to save some of their money funds and either use such savings in business or loan them to others who will do so.

It should perhaps be noted that the discussion here is along somewhat broader lines than that which has concerned us during the larger part of this chapter. For the most part, the discussion has been in terms of the forces that go to determine the rate of interest. The point here has to do with interest as an income to owners who are employing their own money in business operations as well as to persons who have loaned their money to others.

The Amount Received as Interest. — No one can tell what portion of the total money income of the nation is received by the lenders of money or the owners of industrial equipment, but as a result of very careful estimates the conclusion has been reached that about 16 per cent of the total money income in the United States is received in the form of interest, exclusive of the amount that is received by the owners of land in the form of rent. Assuming our total national income to be 65 billion dollars, some 10 or 11 billions of this thus represents the amount that is received as interest. This does not mean, of course, that the interest receivers enjoy one-sixth of the consumable income of the nation. Much of the money which is received as interest is not spent for consumption goods, it is saved. This has already been emphasized in the case of corporations. Thus the amount of real income going to the owners of equipment or the lenders of money is considerably less than the figure

which has been indicated as representing the share of the national income that can be described as interest.

PROBLEMS AND EXERCISES

192. On the basis of the text account for the fact that students borrow money in order to attend college.

193. Develop the point that differences in the business ability of men may lead to the borrowing of money.

194. Show the difference between a period of rising prices and a period of falling prices so far as the demand for purchasing power (loan funds) by borrowers is concerned. Does the rate of interest tend to rise during one period and fall during the other? Explain.

195. Is the demand for purchasing power by borrowers more elastic at high rates of interest or at low rates? Explain. Draw a curve to illustrate.

196. Enumerate several factors that help to determine the amount of savings.

197. If the rate of interest should rise from 5 per cent to 8 per cent, should you expect that certain persons would increase the amount which they save, assuming that their incomes are not increased? Should you expect that any would save less? Would an increase in the rate of interest increase the total incomes of certain persons and thus increase their ability to save?

198. Develop an argument to prove that a heavy tax on luxuries would tend to lower the rate of interest.

199. Account for the early attitude of the Church toward the receipt of interest. See Chapter V.

200. If the cost of building a mile of macadam road is $6500, a mile of concrete road $12,000, and a mile of brick road $18,000; and if the annual cost per mile of keeping the roads in good repair is $600 for the macadam road, $300 for the concrete, and $50 for the brick, which road will be the most economical when the current rate of interest is 2 per cent? When it is 4 per cent? 5 per cent? 6 per cent? 10 per cent? (Parry.)

201. (*a*) "As the interest rate falls the price of income-yielding goods increases." Explain. (*b*) If the interest rate is rising and you were dealing in 5 per cent gold mortgage bonds would you want to buy or sell? Explain.

202. Develop the argument that the length of life affects the rate of interest. Show that a rate of $\frac{1}{2}$ per cent would not be unreasonable if human life were twelve times as long as it is, while it would be unreasonable with life no longer than it is to-day.

REFERENCES

G. Cassell, to whom reference was made above, gives a splendid discussion of the subject of Interest in his *The Nature and the Necessity of Interest*, London, 1903. There is an excellent description of the history of the doctrine of interest in this book. Irving Fisher's, *The Rate of Interest*, 1907, is noteworthy. See also the chapters on this subject in the books listed in the appendix.

CHAPTER LIV

RENT

Rent Defined. — As is unfortunately true in other cases in economics, the word *rent* has more than one meaning. The most common use of the term is to indicate the hire of a piece of property, or the amount paid to the owner for its use. Thus we speak of renting a house, or an automobile, or a costume. But as the name of one of the fundamental sources of economic income, the word *rent* means the income received by the owner of land merely as a result of land ownership. In the other use of the term, it includes payment for labor, interest and the risk of enterprise. As used in this chapter *rent* will mean the amount paid to a landowner for the use of land, or in case the owner uses the land himself, the amount that accrues to him because of his ownership. The term *land*, it should be noted, is used in this sense to mean space upon the surface of the earth. It includes mines, and waterfall sites, for example, as well as what is commonly designated as land.

In the case of a farm, on which buildings have been erected, fences built or tile drains laid, the income received by the owner, and commonly called rent, is not all rent in the sense in which the word is being used in this chapter. A part of the income in such a case represents wages for the work done and interest or profits on the money invested in the construction of the improvements. The term *rent* used in this refined sense is thus what may be called *net land rent*. It is the amount that remains after deductions have been made in the form of payment for services which the landowner may have performed as laborer, capitalist, or entrepreneur. The amount received from a tenant may thus be called the *gross land rent*. The gross land rent and the net land rent are usually approximately the same in the case of land situated in well populated areas, except, of course,

when the rent of houses or buildings in cities is included with the payment made for land. In that case, the net land rent is a relatively small portion of the total, except in the districts where the land rent is very high, as on busy corners in business sections. Almost invariably the landowner must pay some of the net land rent to the government in taxes. Hence we need to distinguish *net land rent* from *net land rent after taxes.* It is the latter which determines the selling price of land, as will be developed presently.

Rent a Price. — Land rent is thus a price that is paid for the use of land. The sum is set, as are all prices, by the forces of demand and supply. The supply of land is so limited in certain sections that more than one person desires to use a given space. This accordingly leads to competitive bidding with a view to determining who shall have the use of the space in question. The owner thus, through the competitive bidding of prospective tenants, receives a payment for the use of his land; or, if he uses it himself he will normally make as much above his expenses as a tenant would pay.

How Much Can Tenants Pay? — (1) In the case of agricultural land, a tenant can afford to pay an amount equal to the excess which he receives for his crops over and above the expenses which are involved in conducting the farming operations. If the net expenses of farming operations upon a given tract of land are $800 per year, including wages comparable to the wages that might be received for working elsewhere, and if the income from the crops is $1200, there will be a net income of $400 per year from the using of this land. That is, there would, in such a case, be an income of $400 above the amount required to pay wages and interest and to return sufficient profit to warrant the undertaking of the farming operations. Under such conditions, tenant farmers will tend to bid against each other until someone offers $400 to the landlord for the use of the given piece of land.

Land may be so plentiful in relation to the need for it, as in some districts during the early pioneering days, that a farmer could not afford to pay rent for the use of a piece of land. If

some land is unoccupied which, because of its soil and location, could be used as advantageously as the land that is under cultivation, the price that could be received for crops would tend to equal the expense of the labor and material used in producing them. That is, if the labor and material expense of producing corn amounted to 60 cents per bushel, and if land were lying idle upon which corn could be raised at a similar expense, the competition of farmers would prevent the price from being above 60 cents. In such a case there would be nothing in the form of rent for the owner of the land. Another phrasing of this is that tenants will not pay a price for using a given parcel of land when other equally desirable land is lying idle and can be had for nothing. Under such conditions land would tend to be a free good. There would be no point to land ownership except as a means of assuring one the title to the improvements placed upon the land, or of profiting later from the increase in land value.

If the population increased sufficiently in such a community all of the best adjacent land would be called into cultivation and the price of products would finally rise above the expense of producing them. This would mean the emergence of land rent. Owners would then be able to exact a price for the use of their land. Land would have become scarce relatively to the demand for it. Poorer land, or land situated further from the established communities, would then be drawn into cultivation. Such land for the time being would not yield rent. The price received for the products from such land would be only sufficient to meet the higher costs of producing them. Subsequent increases in population would mean that still poorer land, or what amounts to the same thing, land which is further removed from the markets, would be brought into use.

The land that is used but that yields only enough barely to pay for its utilization is known as marginal land. It is also described as being on the margin of cultivation or at the *extensive margin.* Any drop in the price of produce will tend to cause farmers to forsake such land and, likewise, of course, any attempt on the part of an owner to extract payments for the

use of such land would cause tenants to refuse to work upon it. Such land is thus marginal and, to repeat, it bears no rent. If the price of corn is 85 cents per bushel, corn that is grown upon such land will tend to involve a farming expense of this same amount, either because of the low fertility of the land or because of its distance from the market, or for both of these reasons. As already indicated, as the population grows and the price of farm products rises, land which had been marginal land will bear rent and land which had been beyond the margin will be drawn into use and for the time being will be marginal land. This extension of cultivation, or increase in the amount of land in use, acts as a check, of course, upon the rise in the rent of the land first brought into use. If such additional land were not available, if the supply of land in use could not be increased as the population increased, land rent would rise far more rapidly than is the case if additional territory may be occupied and the supply of products augmented.

Furthermore, as the price of farm produce rises in a country that is being developed, land tends to be cultivated more intensively. This, also, tends to check the rise in the price of products by augmenting their supply, and thus it too tends to check the increase in land rent. The intensive cultivation of land runs parallel with the extensive cultivation. If the price of corn is 85 cents per bushel, it is not only possible to cultivate land on the extensive margin where the cost involved is 85 cents per bushel, but on every parcel of land that is under cultivation it is profitable to farm it so intensively that certain of the bushels produced will involve a cost of 85 cents per bushel. These bushels are said to be produced at the *intensive margin.*

The important conclusion in regard to the rent paid by tenants for the use of agricultural land is that it amounts to the excess of income over the expense of farming. Such a sum tenants can afford to pay for the use of the land and competition tends to force them to pay such an amount into the hands of the landowner. This sum, as noted above, may be in excess of the *land rent:* a portion of it may be payment for the use of improvements.

Landowners do not, of course, always receive from tenants an amount which is equal to the excess of receipts over expenses. At times, they will get less than this sum, and at other times they may get more than this, thus depriving tenants of proper returns in the form of wages, interest, and profit. The actual rent which is paid by tenants is necessarily only approximately equal to the true gross land rent, that they tend to pay.

(2) The rent of land used for business sites is determined fundamentally in the same manner as is the rent of agricultural land. Rival prospective tenants bid against each other for the privilege of using given parcels of land. The upper limit to their bids tends to be the excess amount which the use of the land will yield above the expenses involved in using it. Competition, of course, tends to give to the owner this amount as gross land rent. The location of land is obviously of exclusive importance in the determination of the rent paid for business purposes. This feature is particularly apparent in the case of retail stores in large cities, such as New York, London, or Paris. In such places certain parcels of land command fabulous prices.

(3) Similarly, in the case of mines, oil fields, forests, or water-power sites, the amount that may be secured above the expense of operation is rent. Such a sum competing tenants (leasees) will tend to offer. The fact that the supply of mineral, for example, will be exhausted as a mine is operated in no way alters the principle involved. So long as the mine yields something over the expense of operation, it bears rent.

(4) In the case of land that is used for residential purposes, a great many factors enter into the determination of the amount of rent that is paid. The fundamental fact, as in the other cases, is that persons compete for the use of a limited amount of space. This competition is more or less intensive, depending upon the population of the city, the wealth of the inhabitants, the social standing of the persons living in the various sections, the distance from the business center, the view that is presented, and the presence or absence of noise, dust or smoke.

Regardless of the use to which land is put, it is very evident from the above discussion that rent tends to rise as the popula-

tion increases. Indeed, it is the increase in population that makes land scarce relatively to the demand for it. If along with the increase in population there is growth in the per capita wealth of the community, rents will be still further augmented.

Rent and Diminishing Returns. — The point is invariably made in the discussion of rent that it is due to the fact that land is subject to diminishing returns. Nothing could be clearer than this. If it were not for the fact of diminishing returns, an acre of land would produce enough to feed and clothe the entire population of the world without any increase in the price per unit of product, and one building lot could house all the retail stores of the country at a cost per unit of merchandising that is found in a five-story building. Indeed, if land were not subject to diminishing returns, an infinitesimal unit of land would yield an infinite amount of produce or service. Under such conditions land would not be scarce, it would be abundant: it would be a free good. But, of course, one parcel of land cannot yield an infinite volume of output. This limitation of produce or service from any one area of land makes land scarce as population increases, and this causes rent to rise. Land is, however, not a whit different from other goods in this respect. If all of the people of a nation could get all of the time-telling service that they want from one town-hall clock, watches would be of no value; and if one automobile would yield all of the automobile service that could possibly be desired, automobiles would not command a price so long as more than one were in existence. But by the very nature of things, the service that any one article can yield is limited. It is this that makes articles scarce — that makes them economic goods. And, to repeat, this characteristic is as true of all other articles of wealth as it is of space upon the surface of the earth.

Rent and the Selling Price of Land. — Since men desire to own land because it bears an income in the form of rent, it follows that the price that will be set upon it will be determined by the rent which it yields, or more properly, by the rent which it is expected to yield. In other words, the amount which one can afford to pay for the ownership of a piece of land is deter-

mined by the present worth of the expected future incomes from it. The expected incomes are discounted into a present value, as has been described in the preceding chapter.

It follows, of course, that if the rent of land is expected to increase, the selling price of land is thereby augmented; whereas if the rent is expected to decrease in the future, the market price is correspondingly reduced. An expected increase in rent means that the present income will represent a lower percentage return upon the market price than would otherwise be the case. Thus, if other similar investments are selling upon a 5 per cent basis, a parcel of land that yields $400 per year and is expected to continue to yield this sum indefinitely, will have a market value of $8000. But if it is expected that the rent of this land is to be increased, the price will rise above $8000. If, for example, it should rise to $10,000, the current income would represent a return of 4 per cent upon the market value, while if the expected increase in rent were such as to carry the present price to $20,000, the current rent would represent an income of only 2 per cent upon the investment. Such a situation must not lead one to conclude that land investments are yielding only 2 per cent, to use the last illustration, for the expected increase in value is such that the total return is reckoned as amounting to 5 per cent interest. Land rent in the United States has almost always represented a very small percentage return on the market price. This is due, of course, to the fact that land in most sections has been expected to increase in value. At times a speculative mania may so greatly overestimate the expected increase in rental that prices are carried far beyond the point which is justified by the income which is later received. Thus in 1820 building lots in Columbus, Ohio, sold for prices which were higher than the prices which they later commanded during the following thirty years.

The relation between the price of land on the one hand and the expected net income and rate of interest on the other was strikingly illustrated when the national government a few years ago attempted to assist prospective farm buyers by furnishing credit at a relatively low rate of interest. It was

believed that such lowering of the rate of interest would be to the advantage of prospective buyers of land. While this undoubtedly proved to be the case in many instances, the general result of this lowering of the interest rate to persons wishing to borrow and buy land was to increase the price that buyers had to pay. This follows from the simple principle of pricing that is applicable to any price that is derived by the capitalization of income, rather than by the cost of production. Thus a parcel of land that yields an income of $1000 per year, assuming that no change is expected in the amount of the income, will at 5 per cent command a price of $20,000. But if the rate of interest should fall to 4 per cent, the value of this land will rise to $25,000.

The Effect of Taxation upon Land Rent. — The effect of levying a tax upon the rent of land has been indicated in earlier chapters. It is perhaps well, however, to refer to the matter again in this connection. As shown in the above discussion, the rent of land is the amount which can be derived from its use over and above the expense involved in utilizing it. Rent is thus a surplus that does not need to be paid in order that production may be carried on. Thus if part of the landowner's rent is taken by the government in the form of taxation, this will not cause him to withdraw the land from use. Hence the supply of products or services from land would not be reduced, their prices would not rise, and land rent would not be affected. Thus the imposition of a tax upon the rent of land cannot be recovered from tenants or from consumers of the products of land.

If, however, a tax were levied upon each acre of land in use, this would fall upon marginal land and tend to force it out of cultivation. Or if a tax were levied upon each unit of product, this would fall upon marginal products and force producers to curtail output. The supply of products would thus be reduced and the prices of such products would be correspondingly augmented. Such a tax would thus be shifted in part, at least, to the consumers of the products of the land. But, to repeat, if a portion of the net rent of land is taken by taxation, no land

is thereby driven out of use and thus the supply of products, or the amount of land service, is not reduced and price is not augmented. Such a tax would thus be borne by the owner.

The relation which has been shown to exist between the rent of land and the price of land points to the conclusion that a tax which is levied upon land value, which is the customary form of land taxes in the United States, is in effect levied upon the rent of the land. The conclusion is then that our land taxes fall upon landowners and not upon tenants or consumers of products. Such taxes confiscate a portion of the net rent of the land to the state. The state becomes a part owner of the land.

This means that the selling price of land is lowered whenever a tax is levied or increased in amount. Thus with the net rent of a parcel of land at $400 per year, and expected to remain so, and the market price at $8000, on a 5 per cent basis, the imposition of a permanent tax of $100 per year would reduce the market price to $6000. A new purchaser of this land would thus, in effect, deduct $2000 from the price that he would otherwise pay. This sum at 5 per cent represents an income sufficient to pay the tax in perpetuity. The new owner thus buys free of the $100 tax. The owner at the time it was levied pays it in perpetuity. The government confiscated $100 per year, or $2000, from the person who owned the land when the tax was levied.

It does not, however, follow from this that a new landowner is free of all taxes, and, therefore, in a favored position so far as tax paying is concerned. The rate of interest at which land income is capitalized is influenced by the general tax rate. If the taxes that prevail reduce the net income from business operations by 2 per cent, the rate at which land income will be capitalized will be 2 per cent less than it would otherwise be. New landowners, along with other persons, are thus burdened by the general tax rate. But new landowners are not burdened by the taxes that are on the land. Their tax burden results from the effect which the taxes that the business community pays have upon the rate at which income is capitalized. If a given parcel of land were entirely free of taxes, and were

expected to remain tax free, the tax burden of a new purchaser would be no less than if the land were heavily taxed. In either case, the tax-free income is capitalized to find the market price, and the new owner's burden depends upon whether the rate of capitalization is high or low, not upon the portion of the land income which he buys.

It follows from this that an old land tax is, in relation to other taxes, burdenless. Purchasers of land since the imposition of the tax have bought free of it. Hence, it is not valid to compare the tax burden of landowners, if such taxes were not recently levied, with the tax burdens of manufacturers and merchants. Further, of course, it follows from the above analysis that any reduction in the long established taxes that landowners pay, is a free gift to such owners of a portion of the net income which they did not purchase when they bought the land.

Rent and the Prices of Goods. — The question of the relationship between rent of land and the prices of land products has been of interest to economists for a long time. Clearly the rent of land that is used for business purposes depends upon the prices received for the products, whether the land be devoted to agricultural, mercantile, or other uses. But does the causal relationship also run the other way? Are the prices of commodities dependent upon the amount of rent that is paid? This question is often stated in terms of costs: that is, is rent a cost of production? But since the issue involved is one of price, it seems preferable to phrase it in price terms.

This question is not merely of academic interest, it is also of practical importance. If the Tariff Board, for example, should wish to determine the price that home producers must get in order to be able to continue producing sheep, should the rent paid for sheep land be considered? That is, must the price received for wool and mutton be sufficient to cover the rent paid for sheep land, or is the rent of this land merely a result of the prices that are received for these products? Again, if a merchant attempts to justify the high prices which he charges on the ground that he has to pay a high rent, is his position consistent with the facts of the situation?

Economists generally have held that the causal relationship runs solely from price to rent, not from rent to price. They have been largely influenced in this opinion by the analysis given by David Ricardo in his *Principles of Economics and Taxation,* published in 1821. His conclusion was: "The price of corn is not high because rent is high, but rent is high because the price of corn is high."

There are two problems here. One has to do with the relation between the prices of land products taken together and land rent; and the other is concerned with the relation of the prices of the various individual goods to land rent. Ricardo, it is said by some, was concerned with the first of these problems. It is argued that he considered corn, which is what we call wheat, as typical of all agricultural products.[1] Taken in this way his conclusion is thoroughly sound. If agricultural prices generally are high, the rent of farm land will be high, whereas if prices of agricultural produce are low, the rents of farm land will be low.

But Ricardo's analysis, whatever he may have meant, has been applied to the altogether different problem of the relation of the prices of individual products to the rent of land. The principle of substitution, the possibility of using land for any one of two or more purposes, makes it inevitable that the land rent to be derived in one use is a factor in determining whether it can profitably be used for some other purpose. If land will command a rent of one dollar per acre as pasture land for cattle, then clearly the price of wool and mutton must be sufficiently high to cover this sum in addition to meeting all other expenses, in order to warrant the use of land for the raising of sheep. That is, the rent which can be received in alternative uses is one of the factors that go to determine the supply of sheep and thus the prices of wool and mutton.

The analysis as to the relation between the prices of individual products and the rent of land is identical with that involved in the case of the relation of wages to the prices of individual products. The prices of goods in general are not

[1] D. H. Buchanan in an unpublished manuscript takes this position.

high because wages are high, but wages are high because the prices of goods are high; however, in the case of any one particular good, the wages that can be received in other employments and that, therefore, must be paid in this line of production are casual in determining whether the one good can be produced, and, if so, how large a supply of it can be produced profitably. That is, the wages that can be earned in any one employment are a factor in determining the volume of output and thus the price in any other line of production, for which the given grade of labor service can be used. If, for example, laborers can earn $5 a day in making chairs, then they cannot be employed at producing tables unless the prices of tables are sufficient to permit an outlay of $5 per day in wages. Thus the wages that may be secured in manufacturing chairs is a factor in determining the supply of tables and thus the prices of tables. The situation is exactly comparable to this in the utilization of land. Since most land may be turned to one of several different uses, the rents that may be derived in any one use becomes a factor in determining the possibility of using the land for some other purpose, and, is thus a factor in determining the prices of such products.

It follows from this that if land has only one possible use, the rent is in no way a causal factor in the determination of price. If a given area can be used only for the pasturage of sheep, the rent received will be a result of the prices received for wool and mutton. It is only the alternative use that is a factor in the limitation of supply in any one line and thus an element in the determination of price. Hence, if land would command a rent of 50 cents per acre if used as a cattle range, the best alternative use, but actually returns a rental of one dollar per acre when used for sheep pasture, only a charge of 50 cents per acre is a factor in the determination of the price of sheep.

Similarly, of course, in the matter of wages. If there is only one task which a person can perform, the wages which he can receive will depend upon the price which the product will fetch. The causal connection will run entirely from the price of the product to his wages; but if he can turn from one occupation

to another, then whether he can afford to do one task will depend upon how much he can make by doing another. The wages that he might earn in one occupation thus become a causal factor in determining the amount of product in other lines of employment and thus the prices of such products.

The traditional defense of the position that rent is not a factor in the determination of the price of any particular commodity is that the price of an article is determined by the cost of production on marginal or no-rent land. That is, if the cost of producing corn at the margin of cultivation is 70 cents per bushel, the market price as a result of this fact will be 70 cents per bushel. Thus since price is set by the cost at the no-rent margin, rent cannot be a factor in the determination of price.[1] This, however, is a very faulty analysis. The price of any product is determined by the total supply of it in view of the total demand for it. The marginal increment of supply is vital in making up the total supply and hence in setting the price. But as pointed out in Chapter XXIX, any producer who would leave a given line of production in the event of an adverse price change is on the margin. There are thus marginal producers all along the line, rather than just on marginal land, as the argument under consideration implies. Some of the growers of corn on land that might be used for a dozen other crops may be far closer to the margin of not producing corn than are any of the farmers who are cultivating marginal land.

In general, the portion of any agricultural crop, manufactured product, or line of retail merchandise, that is on the margin of not being grown, produced, or dealt in, is certainly not found exclusively on marginal — no-rent — land. Indeed, it is on high grade, rent-bearing land that the marginal increments of supply are found rather than on the low grade, marginal land. The persons and firms who are using the rent-yielding land can turn from one line of product to another more

[1] See Fairchild, Furniss and Buck, *Elementary Economics*, 1926, Vol. II, p. 130, for an argument to this effect. They argue similarly, p. 131, in respect to the intensive margin.

easily than can the persons on marginal land forsake it and take up employment elsewhere. Our experience clearly proves this. It is by the extension of production in one line and the curtailment of output in another by the producers on rent-bearing land, rather than by taking up free land, or abandoning marginal land, that the supply of the various products is adjusted and their prices determined. The increments of supply from marginal land are of some importance in this connection but they do not begin to compare in significance as price influencing factors with the marginal increments of supply of the various products that are found on perhaps every parcel of land. Thus the argument that prices are set at the no-rent margin is unsound and of no validity in supporting the conclusion that rent is not a factor in the determination of prices.

A recent study of the number of acres of land devoted to each of the eight major crops in the United States verifies this analysis. It shows marked changes from year to year in the acreage of individual crops, but the increases in the acreage of some are approximately the same as the decreases in the others.[1] Hence the conclusion is in line with that already given: The variation in the supply of individual crops comes from transference from one crop to another and not from the extension and contraction of cultivation.

The argument in question is equally unsound when stated in terms of the no-rent intensive margin. It is not by using farm land or city land more intensively one season and less intensively another that the prices of the various products are influenced through the adjustment of supply to demand. Trade journals do not report as follows: "Owing to a slackening in demand for Japanese parasols merchants may be expected to use their building sites less intensively this coming season"; nor do they say: "Owing to the low price of corn farmers are spending less time in their corn fields than in previous seasons."

[1] See article by the present writer, "Land Rent and the Prices of Commodities," in the *American Economic Review*, June, 1927, Vol. XVII, p. 219. Statistical data were given in this article to show that changes in supply at the intensive margins are also not important in the determination of price.

What is said or implied is that merchants are turning from one line of goods to another, or that farmers are devoting themselves to certain crops rather than to others.

In the study already referred to, an investigation of the production of corn per acre over a period of years led to a conclusion in line with that given above; namely, that differences in intensity of cultivation are not responsible for changes in the volume of a crop from year to year.

This analysis may be summarized by saying that the *margin of transference* is far more significant in the determination of the prices of individual commodities, than are the *extensive* and the *intensive margins*. The margin of transference is not a no-rent margin. Hence, to repeat, the argument that rent does not influence price because price is set at the no-rent margin is not valid.

The central idea in the analysis that has been given here as to the relation of rent to price, is the same, it will be recalled, as that which appears in the chapters devoted to the study of prices. One reason for repeating it is that an appreciation of the fact of alternative choices is most fundamental to an understanding of pricing and thus necessary to an understanding of our economic society. The alternatives that are open to consumers, on the one hand, and to laborers, money lenders, and business men, on the other, lead to such adjustments of supply in the various lines of production that the prices of the various products come to be as they are. The making of alternative choices in the utilization of land is merely one aspect of the competitive choosing by business men that is such a marked feature of our economic life. The rent to be derived in the various uses is the most important factor in the determination of the particular use to which land is put, and is thus of marked significance in the determination of the prices of the various products.

Rent as a Source of Private Income. — Many persons hold that we should not permit land rent to be a source of private income. Land rent, by which we mean net or pure land rent, is payment for space on the surface of the earth. It is not payment for personal service, nor for the loan of money, nor for the risk

of enterprise; it is separate and distinct from wages and interest, and from profit in business. It is merely a toll which the landowners are able to charge for the use of their land, as a result of the pressure of population. What is commonly called land rent, as noted earlier, is gross land rent, and includes payment in the form of wages, interest, and profit as compensation for service rendered. But net land rent is a non-service payment. Hence, the conclusion is reached by the persons alluded to, that the payment of pure land rent to private individuals is in violation of the principle that one should get economic income only by rendering service to the community. Pure land rent, so the argument runs, should go to the government and be used for the common benefit.

It is not possible, of course, to abolish land rent. Land is scarce and it can be allotted to users only on the payment of a price. If the government owned all of the land, rent would have to be charged in order to determine what persons should use the various tracts. Even in a system of communism — in which there is no private property — residential sites could be allocated among the various families only on a basis of rent charges, if justice were to prevail. If equality in income were the rule, the families who were permitted to occupy the choice sites would be given less in food, clothing, or automobiles than were the families who occupied the less desirable sites. This difference in other things would measure the land rent of the choice sites. Land rent is inevitable wherever population is so dense that more than one person would like to have any one plot of ground. But it is not necessary, however advisable it may be, that the net rent of land should be enjoyed by private individuals.

There are two general methods by which land rent might be secured by the government. First, the land might be owned collectively and leased to private firms or individuals. The rent paid by the leasees would then go at once into the public treasury. Second, land might be privately owned and a tax corresponding to the amount of the rent be imposed upon each parcel of land. The owner would thus collect the rent, or receive it in his business, and then remit it to the government.

It might appear that there would be no point to owning land if the tax on it were equal to the rent. Certainly absentee ownership would not profit one in such a case. But in order to have control of a site on which to earn wages, interest, and profits it would be worth while to own land even if all of the net rent were taken by the government. Such land ownership would be comparable to holding land under lease. Of these two methods, the latter, or the tax plan, has more support from those who object to the private receipt of rent than has the proposal for government ownership of land. But there are marked differences of opinion as to the extent to which taxes should be imposed.

The most noted attack in recent years on the private receipt of rent was made by Henry George, an American writer, in a book, *Progress and Poverty*, which was published in 1879. He took the position that the private receipt of land rent leads inevitably to poverty on the part of the non-landowning portion of the population. Since industrial progress tends to increase land rent, his conclusion was that progress and poverty are inseparable so long as land rent is a source of private income. He proposed that all, or practically all, of the land rent should be taken from the owners by taxation.

As a corollary of this proposal, George held that all other taxes, which come necessarily from wages, interest, or profits, should be given up. In other words, his program called for a tax upon land alone. The proposal thus came to be called "the single tax," and George and his followers were called "single taxers."

The advocates of the single tax, or of very heavy land taxes without necessarily giving up all other taxes, have carried on very vigorous campaigns both here and abroad during the past decades. Their zeal has not been entirely unrewarded, as will be noted presently, but in view of the goal which they set they have failed lamentably. The principal reason for this is that their proposal calls for the confiscation of present property rights in land.

There is thus stanch opposition to the proposal on the part of landowners, who alone make a very formidable group. Their

numbers are augmented by property owners who, although not owners of land, fear that a policy of confiscation of property rights in land might be later extended to the confiscation of other forms of property. And, in addition to those who are thus selfishly interested in opposing an increase in land taxes, many disinterested persons oppose the principle of confiscation. Granted, they argue, that net land rent is a non-service payment, an unearned income, yet to the present owners of land it may be as truly a service payment as is any form of income. This may come about as a result of the purchase of land.

Assume that a person has earned and saved $10,000. He may then be said to be earning the yearly income, say, $500, which results from its investment. Hence, if this sum ($10,000) is used to purchase land with a net rental of $500, the rent is an earned income to the purchaser, and for that reason should not be confiscated. The rent may not, however, have been thus earned by the person who has just sold it. He may have bought it for, say, $100, the preceding year and an unexpected development may have raised its price to the figure indicated. If this is the case, the $10,000, or practically all of it, will be unearned by the seller of the land. If then he invests this sum in a steel mill, his income from the steel industry will be unearned. Hence, it will have come about that the income from the land will be earned by the recipient thereof and that the income from the highly important work of making steel will be unearned by the individual receiving it. The confiscation of the right to receive land rent, in such a case, is clearly indefensible. It is only as landowners can be found with land values that they did not purchase — with land rents that have accrued to them as windfalls — that a plan to confiscate them to the use of all of the people of the community, by means of taxation, can be justified. And, then, of course, it is only the windfall — the "unearned increment" — that can properly be taken.

As a result of such considerations, the attack upon the private receipt of rent came to be largely confined to a demand for the special taxation of the increase of land value. This idea came into vogue during the early years of this century. It soon appeared,

however, that the taxation of an increase in land rent, or land value, might easily be confiscatory. The market price of land, as explained above, is the present worth of the expected yearly rentals. Thus if rentals are expected to increase, the purchase price is thereby augmented, and to decree that such later increases in value will be confiscated will necessarily depress the present price. This fact was not appreciated for some time after these proposals were first made. For example, Lloyd George, the English statesman, in his campaign for the "unearned increment" tax in 1909, declared that the aim was to take all of the increase in value but not one farthing from the present value. Obviously, this was impossible if it was at all expected that land would increase in value. Expected increases in value enhance the present price. Thus to arrange to confiscate the anticipated future increments will reduce the present value.

Reflection also showed that even if land is not definitely expected to increase in value, a provision that any increase will be taken by the government will tend to depress the present price. This comes from the fact that even a remote possibility of an increase in value is a factor in setting the price of land to-day. To remove the possibility of gain would thus lower present land prices. But present values in such a case would, of course, not be affected nearly so appreciably as when increases in value are definitely expected.

The effect of definitely expecting land income (or value) to increase is also very important for our problem from another point of view. That is, it is possible that the increase in value may have been so accurately anticipated at all times that a rise of value from zero to an inordinate sum would not have permitted any owner to receive more than a normal rate of interest upon the money invested in the land. In other words, the rent received may have been earned income, upon earnings made in business, to all persons who may have owned the land in question as it rose in value. Let us suppose a somewhat unreal case to illustrate the point. If a given acre of land yields 20 cents net rent for the present year and if the rent is

definitely expected to increase by 3 per cent each year for an unlimited period, the market price of the land will tend to be $10 during the year in question, if 5 per cent is the rate of capitalization that the market uses in computing land value. The current income is capitalized at 2 per cent. This rate, plus the appreciation in value of 3 per cent, makes a total of 5 per cent on the sum thus set. The value of this land would be, then, $10 the first year, $10.30 the second, $10.61 the third, and so on, the value appreciating 3 per cent each year. Under such conditions, whether the land were held by one man over a long period of time or bought and sold very frequently, the income and the added value would amount to only 5 per cent per year on the sum paid for the land, even though the price rose from $10 to $100,000.

It is also interesting to note the problem of public ownership in such a case. When the land is worth $10,000, can it be said that the city or state should have purchased it when it was worth only $10? Under the conditions assumed the gains and current rent would have amounted to only 5 per cent income, whether the land were held by the government or by a private owner. There is, however, an additional consideration in the case of government ownership. The cash income, as assumed, is only 2 per cent per year, the appreciation in value being 3 per cent. To buy a tract of such land for $10,000, with money raised by selling 5 per cent bonds, would thus mean a yearly outgo of $500 for bond interest and a cash income of only $200 from the land. The following year the cash income would be $206, but it would not be until thirty-one years had elapsed that the rent from the land would amount to $500, and thus equal the outgo for interest on the bonds. Thereafter, of course, the yearly cash income would exceed the interest expense. Thus the purchase of such land by the city would mean that the taxpayers of the first thirty-one years would be assuming a net expense for the benefit of later taxpayers.

This leads to the question as to whether a city could afford to keep such land if it should acquire it by gift. To sell it for $10,000 and loan the money at 5 per cent interest would bring

a cash income of $500 per year, but the land would not yield such a yearly income until thirty-one years later. If the city should hold such land it would be discriminating against the present taxpayers in favor of those of the future.

But, of course, the future increases in land value are not always accurately anticipated, and as a result of this lucky buyers are enabled to make large "unearned" gains. The basis for many of the largest American fortunes came from the gain in land value which the market had not anticipated at the time the fortunate persons acquired the land. The very high prices now attached to the choice sites in perhaps all of our two hundred largest cities represent large unearned gains to early investors. Likewise, the enormous gains from oil lands are almost all windfalls to the lucky owners of the land at the time oil was found. Similarly, the rent from many mines has not been anticipated from the beginning. To provide that such windfalls should be taken by the government when they accrue in the future would not depress present land prices, and thus would not confiscate property rights.

The problem, then, if it is desired to turn unearned increases in rent into the public treasury, is to exempt such increases as are anticipated. Since anticipated gains are capitalized (discounted) at the rate of interest that is applied to land investments, with a deduction for current rent, if any, it follows that a provision to tax all increases over such rate of interest would not depress the present price. Thus, in the illustration used above, a provision that any increase in rent (or value) over 3 per cent per year shall be taken by the state would not have affected the price of the land. Or, if land were lying idle, a provision to tax away any increase over 5 per cent per year would not lower the market price, if 5 per cent is the rate of capitalization used in computing the price of land. With a 5 per cent rate, land cannot be expected, by the market, to increase more than 5 per cent per year. Such a condition is mathematically impossible. The future expected price and the present price are necessarily tied together by the current rate of discount. Hence, to provide that gains of more than 5 or 6

per cent per year shall be taxed away would permit the government to secure the unusual gains and would not confiscate any of the present value of land.

Further, if a campaign for such taxation should be carried on for a period of years, and should be expected to result in a confiscation of all of the increase in value, land prices would have been so adjusted that it would not be necessary to exempt any portion of value increases in order not to confiscate the rights of the then owners. The persons who had owned land at the time that it came to be expected that all increases in value would be confiscated would be the ones who suffered. The new owners would have purchased in expectation of the new laws.

Special taxation of increases in land value has been provided in England, western Canada, Australia, and many European cities.

Although it is not conceived as a special tax on the increase in land value, the general property tax does have this effect, as noted in Chapter XLIX. The reappraisals that are made from time to time usually mean, especially in cities where land values are increasing rapidly, that the tax receipts from land are increased, and thus that a portion of the increase in rent is converted into the public treasury.

Private *vs.* Government Land. — Whether it would have been well for our government to have retained title to the land and leased it for use, is an interesting question. The lure of expected land rent certainly encouraged migration to the West during the whole of the past century. Private ownership may thus be credited with having hastened the settlement of the country. The land would eventually have been settled even under a leasing system, but the process would have been slower.

The private ownership of agricultural land has a marked advantage over government ownership. The maintenance of the fertility of farm land is of great social importance, and it is reasonable to believe that perhaps no system of government leasing would lead to the exercise of the same degree of care that is found under private ownership. Tenants would, under such a system, receive wages, interest, and profit, but they could

not look forward to gain as a result of an increase in land value. Further, except the leases were for long periods of years they could not be confident of their ability to hold the land, and thus would be deterred from attempting to conserve or improve the fertility of the land. Then, too, under government ownership the task of allotting land to tenants and supervising the use of it must be borne by the government. This work is now performed by the landowners. The rent which farm owners get is not large and, especially, the net, in addition to the payment for such service, is not large. Thus our society as a whole has perhaps not paid more for the directive work of farm owners than it would have paid under government ownership. Then, too, as just argued, the agricultural product under private ownership has undoubtedly exceeded the product that would have been realized under government ownership.

In the case of city land, a system of long term leasing might have been entirely satisfactory. That this would perhaps not have deterred the improvement of land is evidenced by the fact that some of our largest buildings are erected on land that is leased, not owned, by the firms that own the building. Government ownership and leasing would have left no place for the work of the real estate promoter in developing "additions." Large tracts of land of our large cities would then not have been withdrawn from agricultural use long before the land was needed for building sites, and the energy of lot salesmen would have been available for productive work. In general, city development would perhaps be carried out much better under government ownership of the city land than under private ownership. The releasing of land under government control would, of course, give to the city treasury the benefit of the increase in land rent.

In the matter of land containing oil and gas there seems to be no question at all as to the advisability of government ownership. The record of the waste of these two valuable products under private ownership in the United States is appalling. Competitive drilling into single pockets of gas and oil, when one well would have drained the entire area, has been not only

wasteful of labor and materials required for drilling, but has led to enormous wastes of product. The permitting of private ownership and operation in these fields has been a tragic blunder on the part of the people of the United States.

The record of private enterprise in the case of our mineral deposits is far from being as bad as in the case of gas and oil. But especially in the mining of soft coal conditions have long been deplorable. The over-development of the industry under the quest of profits has led to chronic unemployment and has been productive of great bitterness on the part of the miners. Ownership by the government of all mineral, oil, and gas deposits could easily have been secured without altering the general policy of private ownership, by specifying in the deeds, as is done in Canada, that all such elements beneath the land are reserved to the government.

The portion of the total national income that accrues to landowners is very considerable. As given in a following chapter,[1] land value, exclusive of improvements, is estimated to make up over one-third of the total wealth of the nation. But this would mean that the income accruing to landowners is far less than one-third of the total national income, since non-property income is a large part of the total.

PROBLEMS AND EXERCISES

203. Consider the rent that is charged for rooms. Estimate the portion of this that is pure land rent.

204. If the price of potatoes is $1.10 per bushel, what sum would be paid for the use of an acre of land that yielded 200 bushels of potatoes at an average cost of $1.00 per bushel? Would the tendency be for any of these bushels to cost the producer $1.10? Explain.

205. (*a*) If the price of corn is 95 cents per bushel over a period of time, what will tend to be the cost of producing corn on the poorest land that is being cultivated? Why? What is such land called?

(*b*) What will tend to be the cost of production at the intensive margin? Upon what land will corn be grown at the intensive margin? Explain.

206. "Rent is due to the fact of diminishing returns." Is this true? Discuss.

[1] Chapter LVI.

207. A certain piece of land yields 20 bushels of wheat per acre, — the expenditure per acre being $10. With land on the margin of cultivation yielding 10 bushels for the same expenditure, and with the rate of capitalization 5 per cent, what value would an acre of the 20-bushel land tend to have when there was a tax on it equal to 80 per cent of the rent? Put down in your answer each step in the solution, and explain fully. (Taylor.)

208. If land income is capitalized at 5 per cent, what will be the effect upon the value of a parcel of land if a tax of $100 per year is levied upon it? Explain. Why is it that a land tax cannot be shifted to the consumers of the products of land?

209. Why should a long standing land tax not be reduced? By what argument might the owner insist upon a reduction? Illustrate. Examine his case.

210. (*a*) Assume a case in which the rent of land used for growing corn will be a factor in determining the price of corn. (*b*) Assume a case in which the rent of land that is devoted to growing corn is not a factor in determining the price of corn.

211. "Price is set at the margin." "Price is set at the margin of cultivation." Are these two propositions the same? Explain.

212. Give a case to illustrate the influence of the margin of transference upon the price of a commodity.

213. (*a*) What is the argument by which the conclusion is reached that private individuals should not be allowed to receive land rent? (*b*) Construct an argument to the effect that it is desirable that private individuals should receive land rent. (*c*) Give another argument to the effect that rent should not have been permitted as a source of private income, but that since this was begun justice requires that the custom should be continued, in part, at least.

214. If the income from land and its value is increasing by 3 per cent a year and if land income is capitalized at 5 per cent, what will a piece of land be worth that is bearing a rental this year of $300? If money was borrowed at 5 per cent to buy this land, how many years would have to elapse until the income became equal to the yearly interest payment on the amount borrowed?

215. "Sixty years ago the state should have purchased a large quantity of land and held it for school purposes." Discuss the bearing of the rate of interest, the increase in value, and the interests of the taxpayers of one generation as compared with those of another in determining the proper procedure in such a case.

216. "The price of land has gone up and so the landlords are asking more rent." Is this reasonable? Explain.

REFERENCES

"The origin of Agriculture Rent" by F. M. Taylor, is an exceptionally able presentation of the subject indicated by the title to the essay. This appears in a book of readings by Taylor. *Outlines of Land Economics*, 1924, by R. T. Ely contains much excellent material. A discussion of rent can be found in almost any of the books listed in the appendix. *Progress and Poverty*, 1879, by Henry George, is a very cleverly written book, attempting to prove that poverty accompanies progress because of the private receipt of land rent. Chapter II, Book III of that work gives a good description of the origin of rent.

CHAPTER LV

PROFITS

Terminology. — *Profits* is another term in economics that is used to express more than one idea. In its most general sense it means the money returns above expenses from a business venture, or, in other words, total receipts minus expenses. But within this general meaning there are many different meanings depending upon the items that are included as expenses in computing profits. Thus a farmer might say that the profits from a year's operation of his farm amounted to $4000, meaning that this sum of money remained after all money payments had been made. In such a case, the $4000 would include the wages of the farmer, interest on money invested in farm equipment, and rent from the land. Another farmer in computing his profit might exclude any, or all, of these items. Perhaps the usual use of the term in the case of business units that are individual proprietorships is as in the case of the farmer first referred to above; namely, to include the wages that might be imputed to the owner-manager, and the interest and rent that might be imputed to his holdings.

Corporations follow various methods in arriving at what they call their "profits." Wages of managers and of other laborers are normally not included as part of profit, for corporations almost invariably pay out money for such services. The directors of a corporation, however, may render conspicuous personal service for which they are not paid. To the extent that this is true, the profits item will include wages that might be imputed to the directors. This would not mean, however, that what are called profits are thereby less truly profits to the corporation. The receipt of the free service augments the total profits.

Imputed interest on the investment of the corporation, part

of which may be land rent, is usually included in "profits." Thus to say that a corporation has made 15 per cent profit normally means that it has earned above outgo an amount equal to 15 per cent of the capital stock. If interest upon the capital stock be reckoned at 6 per cent this would mean that excluding imputed interest, the rate of profit would be 9 per cent.

If the item called *profit* includes an amount that could be imputed to labor service as wages, or to owners as either interest or rent, economists commonly describe this as *gross profit*. *Net profit* is, accordingly, said to be the amount remaining to the owner of the enterprise after deducting such sums as may be imputed as wages, interest, or rent. The amount to be thus imputed depends upon the wages that the manager-owner might have received as an employee, or the interest or rent that he could have secured by permitting other persons to use the property in question. In other words, *net profit* means the net return to an entrepreneur after providing compensation for all of the labor, capital, and land used in the enterprise; it is the net income to the entrepreneur, as an entrepreneur, exclusive of his income as a laborer, capitalist, or landlord. Net profit is thus the income received for undertaking a business venture — for assuming the risk in an enterprise — provided the undertaking is successful.

Losses are the counterpart of profits. And as is true of the word *profit*, the term *loss* is used in several different senses. If a net profit is not secured, but if imputed wages, interest and rent are earned, the result is not commonly said to be a loss. Nor is a loss usually said to occur if nothing is received as imputed wages, interest, or rent, provided the property ownership is not impaired, although, of course, the statement is often made that one has lost wages, or interest, or rent as the case may be. As corporations usually count profit as any return in excess of outgo without regard to imputed interest or rent, so they commonly regard loss as an excess of expenditure over receipts.

The amount of profit or loss is stated in terms of dollars or as

a percentage of the amount of property involved. Computed as a percentage, different results are derived, obviously, as the base used varies. Among the bases commonly used are the amount of money actually invested, or, in the case of a corporation, the common stock, the preferred stock, or both, or these items plus the amount represented by long term bonds. Perhaps the usual practice among corporation accountants is to allow for interest on bonds, and dividends upon preferred stock, and regard the amount then remaining as profit upon the common stock. The different possible methods of computing the rate of profits has led to the practice of specifying the base in reporting the rate of profit. Likewise, loss as a rate may be computed on different bases. For this reason it is also a common practice to specify the base used in any particular case.

As implied in the foregoing, business profits are residual — not contractual sums. The other shares in the distribution of a nation's economic income — wages, interest, and rent — are usually stipulated by contract in advance of the receipt of the service for which they are to be paid. The exceptions to this rule are found when one works for himself or uses his property in his own business. Contracts are sometimes drawn in which one party is to receive "cost plus a given rate of profit." But this is using the term in an unusual and, therefore, a somewhat unwarranted sense.

The Causes of Profits. — Profits are very largely attributable to two conditions of economic life; namely, (1) the changes that take place in supply and demand relationships, and (2) the differences that prevail in the business ability of men. The first of these may properly be regarded as the primary cause of profits and the other as a secondary cause.

Changes in Supply and Demand Relationships. — If there were no changes in economic conditions — if weather conditions were unalterable, if the number of persons never varied, if the products and services that are offered for sale at particular prices were always the same, and if the demand for products and services were unchanging — in short, if the supply and demand conditions in every line of economic endeavor always re-

mained the same, there would be no profits, and neither, of course, would losses ever occur. Under unvarying, unchanging conditions or, what amounts to the same thing, regular, orderly, predictable change such as the day by day variation in the period of sunlight throughout a year, the entire social income would be divided into three parts, wages, interest, and rent. This is apparent if one assumes changes to become less and less marked over a period of time until a condition of no further change is reached. During such a period business men would turn from the less profitable to the more profitable lines of business, and as this movement went on, wages and interest, and rent would be bid up until profits were eliminated.

But nothing could be further from truth than an assumption of unchanging or predictable conditions. The most patent fact of life is that changes are ever taking place — that new situations are always arising. The physical structure of the surface of the earth is constantly undergoing change, weather conditions vary from year to year, animal and vegetable life alters constantly — all things are forever changing. The number of persons, the wants which they have, and the means which are available to satisfy them are in constant flux. The goods and services which are offered for sale vary from time to time in kind, quantity, and price, and the goods and services which people wish to buy and the prices at which they can or will take them are likewise subject to constant alteration.

It is in these changes that the opportunity for profit and the possibility of loss reside. For, it is because of them that the competitive forces fail to bring selling prices and cost prices into such a relation to each other that profits would be eliminated. The monopoly profits that come from trade secrets, patents, or the good will of the public are due to the changes that have recently transpired. Further, as prices alter, as selling prices rise or cost prices fall, profits result; and as opposite changes take place losses occur. As new articles tap new demands at prices above costs, profits are made by the business men who are in such fields, and losses are the lot of those whose former patrons purchase the new commodities.

(1) *Changes ~~in Demand.~~* ~~—~~ Periods of great change necessarily offer the greatest opportunity for profits and the greatest chance of losses. A war, if it is of considerable proportions, enables the persons who are engaged in "essential" industries to command high prices and to reap large profits, while those whose lines of production are not essential to the conduct of the war may suffer very heavily because of the shift in demand away from their products. A buying mania of any kind brings profit to sellers and losses to the would-be sellers who lose their markets as a result of the new buying. A land boom, for example, brings profits to land dealers and to all auxiliary sellers, but by directing spending away from accustomed lines tends to cause losses in other fields.

(2) *Rising Prices.* — Periods ~~of rising prices — which~~ usually accompany wars — generally augment profits, for if prices are rising, finished products, being later in point of time, are sold on a price level above that on which equipment, materials, and other requisites to production are purchased, and almost any good can be resold at a later date at a price above its cost to the seller. Profits from rising prices tend to be somewhat general throughout a community, that is, the losses that often accompany profits, as noted above, do not normally take place in a period of rising prices. A marked exception to this general rule is found in the case of industries whose prices are fixed by law or by public authority and hence are prevented from rising as freely as costs do. Public utilities may thus suffer heavily in a period of rising prices.

Data showing profits in America during the European war, which was accompanied by a marked rise in the price level from 1914 to 1920, illustrate the above analysis. Mining and manufacturing corporations earned in 1917 three and a half times as much as in 1913, which was the highest pre-war year. The profits enjoyed by wholesale and retail firms during this period were very substantial, but somewhat less than the rate received by mining and manufacturing corporations. Financial corporations (banks, insurance companies, and closely related institutions) gained less than the mercantile firms, while rail-

roads and public utilities suffered considerably after 1916 and 1917.

The railways and public utilities gained during the first years of the war because of the increased patronage which they enjoyed, but from about 1917, their increased expenses, as a result of the rising price level, together with the pre-war rate schedules led to heavy losses. There were some increases in rates in 1918 and 1919 but on the whole they were not considerable. Twenty-four selected public utility corporations show net earnings as follows for this period:

TABLE 13

Net Earnings of 24 Public Utility Corporations[1]

Year	*Net Income*
1913	$ 91,152,373
1914.........	92,184,608
1915..........	109,875,718
1916..........	124,497,517
1917.........	110,453,890
1918.........	90,968,565
1919.........	92,582,364

The 1918 earnings were thus far below those for 1916 and even lower than those for 1913. The earnings for 1919 are but little better being only approximately equal to those for 1914. The rising price level was bad for these corporations. This situation is also shown in the prices of railway stocks. Twenty railway stocks averaged $76.22 per share in 1920 as against $113.69 in 1913. In striking contrast, twenty industrial stocks averaged $103.49 in 1920 as compared with $65.71 in 1913. The one group fell $37.46 per share and the other rose $37.78 per share during these seven years.[2]

A period of falling prices tends to cause losses, or at least to bring a marked check to the continuation of profits. The ex-

[1] David Friday, *Profits, Wages and Prices*, p. 169.

[2] Friday, *ibid.*, p. 22.

ception here is again the industry whose selling prices are fixed, but whose costs fluctuate with the general price level.

(3) *New Lines of Industry.* — As already indicated, the development of new lines of industry offers great opportunity for profit, as the new products may meet with such popular approval that their prices can be set considerably above their costs. Thus the development in America of the steam railways, the oil industry, the telephone and telegraph, street railway transportation, electric light and power, and the automobile, has led to the acquisition of profits sufficient in many cases to amount to colossal fortunes. But, of course, the projection of new lines of production that are not successful involves losses. These, however, are but little heralded.

In general, the past sixty years (1868–1928) have offered unusual opportunities for the making of profits. These years have been very unique in the world's history in the degree to which changes have taken place in the economic realm of life. New inventions, new methods, new articles, and a changing and constantly expanding demand have been marked characteristics of this period, and profits — large profits — have been their concomitant.

Business Ability. — The changes in supply and demand that have been noted above give opportunity for the making of profit, but in almost all cases the exercise of business judgment is essential to the securing of profit. In some cases, to be sure, profit represents mere chance or luck, — a throw of the dice; but perhaps in most cases keen business judgment is involved.

In a given situation some persons will sell, others will buy; some will adopt new methods, others will refuse to do so; some will extend operations, others will not; some will enter new fields, others will stay in the old ones; some will follow one labor policy, others another; and some will advertise much, and others not at all. The later profit and loss accounts of these different men will show the business merit of the decisions that were made.

Not only are there momentous decisions that must be made occasionally, and that vitally affect the business success of an

individual or firm, but every one of the many day by day decisions that a business manager makes tends to alter the profit or loss of the enterprise. Indeed, the very fact that a problem exists — that alternative choices are possible — normally means that results will be altered as one or another decision is made, for seldom are alternative choices identical in all respects. And in making a decision in business, or elsewhere, there is no golden pattern. The decision that should be made will depend upon the total situation and that is forever changing.

Imagination, initiative, analytical ability, courage, ruthlessness, and honesty are among the factors that determine the decisions. As situations differ, now one and now another combination of these qualities will make for success or failure. A high degree of courage, for example, may in one instance lead to large profits and in another lead to heavy losses. Dishonesty and a ruthless disregard of the rights and interests of others are, of course, outside the pale of ethical business conduct, but unquestionably these qualities have often contributed to the acquisition of profits of enormous proportions, and, they also have often led to severe losses. Although there is considerable evidence to the effect that business conduct is becoming more and more ethical, dishonorable practices must still be reckoned among the factors accounting for the success of certain men, and, as well, for the failure of others.

The relation between business judgment and profit is similar to the relation between speed and victory in a foot race; there must be differences among the contestants if one is to win. Winning depends merely upon one's prowess relative to the others and not upon the absolute degree of skill which the group of contestants possess. If all business men had perfect business judgment, profits would not exist. Such judgment, by anticipating all the changes in supply and demand relations would completely negative all of their effects; it would be as if there were no changes at all. That is, to the extent that business men have good judgment they tend to prevent each other from making profits. If a dozen men, or even only one, had duplicated the judgment of Henry Ford at every stage in

the early development of his enterprise, Ford's business could not possibly have assumed the proportions that it has. His enormous profits have come because of the superiority of his judgment and that of his co-workers, as compared with the judgment of other business men.

The validity of this analysis is not impaired by the fact that all of the persons in one field of business may receive profits or suffer losses at the same time. Thus in the farming industry in which the product of one farmer cannot be distinguished from the product of another, a group of farmers or all of them tend to gain or lose together depending upon the general state of the crops as compared with the market for them. But this means only that in some one season all of the persons who decided to sow wheat, for example, exercised better judgment than did other farmers and other business men who decided not to grow wheat during the season in question.

TABLE 14

RATE OF EARNINGS OF 237 SHOE MANUFACTURING FIRMS, 1917 [1]

Per Cent of Earnings on Investment	*Number of Firms*
142	1
98	1
76	1
60–69	4
50–59	3
40–49	16
30–39	41
25–29	27
15–24	75
0–14	60
Loss	8

The relation between business judgment and business success is also illustrated by the relative earnings among the firms in one industry. The Federal Trade Commission made a study

[1] Federal Trade Commission, *Report on Leather and Shoe Industries*, August, 1919, p. 103.

of the earnings of 237 firms engaged in the manufacture of shoes, covering each of the four years 1914–1917. The situation in 1917 was typical for these years. In that year the distribution of firms according to earnings on net investment as computed by the commission was as follows:

The rate of earnings varied all the way from losses to 142 per cent on the investment. Seven of the 237 firms earned 60 per cent or more, and 8 suffered losses. The differences among these firms were very marked.

The element of management in the success of the enterprise is further emphasized by noting that there was not among these firms any relation between size of plant and rate of earnings.

TABLE 15

RATE OF EARNINGS ON INVESTMENTS OF 237 SHOE MANUFACTURERS GROUPED ACCORDING TO AMOUNT OF INVESTMENT, 1914–1917, INCLUSIVE [1]

Groups	*1914*	*1915*	*1916*	*1917*
	Per Cent	*Per Cent*	*Per Cent*	*Per Cent*
Under $100,000 — 85 companies.	12.8	14.6	31.5	26.5
$100,000 to $250,000 — 56 companies....................	16.7	15.8	25.2	22.5
$250,000 to $1,000,000 — 74 companies..................	15.5	15.2	26.6	25.0
$1,000,000 to $3,000,000 — 14 companies.....................	15.0	15.5	26.3	20.3
Over $3,000,000 — 8 companies..	14.7	14.6	25.4	26.3
Average	15 1	15.0	26.1	24.7

If profits varied according to size this might be due either to superior management in the large plants or to the economies of large scale operation, which might be ascribed to the good fortune of having control of enough money to make a large establishment possible. But with no correlation between size of plant and rate of profit, as is indicated here, the conclusion tends to follow that the ability of the managers in the different plants is the important consideration. Further, of course, in

[1] *Ibid.*

so far as one size gives advantages over another, the able manager is the one who restricts the size of his plant, or enlarges it, if the advantage lies that way, providing he can secure the necessary funds.

Losses. — Losses, which are the opposite of profits, deserve additional consideration. It has been noted that of the 237 shoe manufacturers, 8 suffered losses in 1917 and at the same time 7 made profits of 60 per cent or more on their investments. The annual reports of Dun and of Bradstreet show that about 1 per cent of all of the business firms in the United States fail each year. These data, however, include only the cases where creditors lose and these are a very small part of the total number of failures. This is indicated by the fact that these reporting agencies in some years remove from their lists of firms in business as many as 20 per cent of the total number of the names listed.[1] Special studies by the publishers of *System* have revealed a high rate of failure among business firms. One study covered 1327 factories, 492 wholesalers, and 2550 retailers. It showed that 62 per cent of the factories, 51 per cent of the wholesalers, and 58.6 per cent of the retailers failed within thirty years.[2] Many of these involved no loss to creditors and thus never reached the bankruptcy courts, nor were they reported by Dun or Bradstreet.

Other interesting data relative to business success and failure are found in the reports which corporations make to the Bureau of Internal Revenue. In the year 1925, which is generally considered to have been a good year for business, 177,738, corporations, or 41 per cent of all those that reported, had deficits, amounting in all to almost two billion dollars. In 1921, more than half of the corporations reported losses. The following table shows such data for a period of six years.

The losses shown in the second part of the table are presumably the result of the non-insurable hazards of business. The

[1] P. D. Converse, *Marketing, Methods and Policies*, 1924, p. 378.

[2] See: "What Can We Do About the Business Death Rate?" *System*, January, 1916; "Will You Have a Business in 1924?" *System*, January, 1917; and "When Will My Business Die?" *System*, October, 1917. Quoted in Converse, *ibid.*, p. 376.

high rate of loss indicates the differences in the business ability of men, and the element of luck, and it also suggests the necessity of profits as an offset to losses if persons are to be encouraged to risk their money in new enterprises. This point will be discussed presently.

TABLE 16

NET INCOME AND DEFICIT OF CORPORATIONS [1]

	Corporations Reporting Net Income		*Corporations Reporting No Net Income*		*Income in Excess of Deficit*
	Number	*Net Income Million Dollars*	*Number*	*Deficit Million Dollars*	*Million Dollars*
1920	203,233	7,903	142,362	2,029	5,874
1921	171,239	4,336	185,158	3,878	458
1922	212,535	6,964	170,348	2,194	4,770
1923	233,339	8,322	165,594	2,014	6,308
1924	236,389	7,587	181,032	2,224	5,363
1925	252,334	9,584	177,738	1,963	7,621

Business Forecasting. — As indicated in preceding chapters,[2] business men have been giving a great deal of attention recently to the careful assembly and analysis of data with a view to determining probable future conditions. This is commonly called *business forecasting*. Forecasting based on "hunches," guesses, and judgments is as old as business, but it is only within the past few years that business men have sought the aid of expert statisticians in prognosticating business trends. This work gives promise of being very valuable in improving the quality of the business judgment of the managers of the firms that make use of it, and will thus tend to enlarge their profits.

But as such practice is extended, profits to the whole group of business men will tend to become less. For, as already indicated, to the degree that perfection is attained in business

[1] Data from the Bureau of Internal Revenue, quoted in the monthly bulletin of the National City Bank of New York, January, 1928, p. 3.
[2] Chapters XI and XXXII.

judgment, profits tend to disappear. Thus the perfecting of the art of business forecasting means a movement in the direction of the elimination of profits, and also, of course, losses. From the point of view of social welfare such a tendency is to be greatly welcomed: economic change without the pitfall of losses and their accompanying disorganization is a consummation devoutly to be wished. But it is by no means to be expected that business forecasting can be so perfected that economic conditions can be exactly anticipated in a society that is as marked by changes as is ours.

Price Stabilization. — The stabilization of prices, which has also been discussed previously,[1] points toward a reduction of profits and losses. Obviously, if the general price level remained unchanged, the opportunity for profit and the chance of loss would be reduced. It is possible that some progress may be made in checking fluctuations in the level of prices. Control of the volume of bank credit by banking institutions, such as our Federal Reserve Board, may accomplish much in this particular. But it is undoubtedly going entirely too far to expect that such control of credit will prevent price movements. As was noted in the chapter referred to, there are many factors that influence price movements of which the volume of credit is only one. The control of all of these is perhaps impossible.

But it must be remembered that even with a stable price level — a uniform average of prices — profits and losses would still occur. The prices of individual commodities would tend to change even if the average level of prices did not. But aside from any price changes, the alteration in the cost of production, and shifts in demand from the patronage of some firms to the patronage of others would enable some persons to reap profits and cause others to suffer losses.

Wages of Managers and Profits. — Two questions may arise in regard to the above analysis that makes business ability play such a large rôle in the securing of profits. First, should not the income that thus accrues as a result of the exercise of business judgment be termed wages rather than profit? And,

[1] Chapter XXXI.

second, why do not business firms bid up the wages of managers until profits as a result of business ability are wiped out?

The distinction between wages and profits is, as already indicated, that the former is contractual in nature while the latter is residual. The latter, too, is dependent upon the use of property while the other is not. To use property, necessarily requires the exercise of human faculties, and the amount secured thereby may be in part imputed to wages. But a sum beyond the amount that the individual could have secured from an employer cannot properly be called wages. It is the return for venturing his property: it is profit. Further, even if the earnings of a firm are very properly attributable to a manager and his assistants as wages, the fact that they are not paid out as wages makes them profits to the owners.

The second question has already been answered in part. Since the use of property in business by an owner, rather than by a creditor who has good security, involves a chance of losing it, one who is at all cautious would not be inclined to pay a manager, or a group of managers and laborers, so much that he could not reasonably expect to realize a profit from his investment. That is, the possibility of loss tends to check the bidding of firms for managers at a point that will leave a margin of profit, if all goes reasonably well. Thus the chance of loss by owners prevents managers from getting the amount which they add to the earnings of the business, over and above interest and other charges, when they are fortunate in their judgments.

Furthermore, men are not, strictly speaking, economic men. One does not in all cases press his co-workers or employers for all that might be obtained. Thus a person who has been engaged by a certain firm for a period of years may through reluctance to press his claim for higher wages contribute to the profits of the enterprise. There are, of course, owners who are not cautious and who overbid in hiring managers and laborers. These do not make profits; they lose.

Is the Receipt of Profits Justifiable? — The question as to whether the receipt of profits by business men is justifiable turns, as do all similar questions, upon the general effect of

the practice upon social welfare. Cases may easily be cited in which the profits secured are entirely unrelated to the performance of service, as, for example, the purchase of a parcel of real estate and its resale at an advance in price, or buying and selling at a profit on the stock exchange. But the fundamental question in relation to these transactions is, should real estate and shares of stock be owned by private individuals? If the answer is in the affirmative, then it necessarily follows that individuals must be permitted to make profit in dealing in such things. For freedom to buy and sell is a necessary part of private ownership. It may be regrettable that certain persons get claims on their fellows without rendering service, that is, by making profit merely by buying and reselling. But, to repeat, this is incidental to the broad principle of private property.

Further, profit from the operation of a business enterprise is a necessary concomitant of private property, and of individual initiative, which is part of the system of private property. That is, the use of private property involves the securing of gain if one is fortunate, and the suffering of loss if the enterprise turns out badly. Indeed, the fact that loss is always possible in the use of property makes it necessary in a system of private property that one be allowed to enjoy profit in order that the use of property will be encouraged. This is particularly true of the utilization of property in new and, therefore, hazardous enterprises. In other words, profit to successful business men is part of the price that a society that is based upon private property must pay in order to have experimentation — the development of new lines of enterprise and the use of new methods — in the production of goods and the conduct of business.

Then, too, aside from the production of new goods and the utilization of new methods, it is through the mechanism of the receipt of profit that a balance is held among the various lines of production: it is in this way that economic energy is apportioned among the different enterprises. For as profits increase in one line this tends to draw business men into the production of the good in question, and as losses are incurred, certain lines of production are abandoned.

The point at issue is often given a somewhat different phrasing, namely, that an owner should not enjoy profits to the exclusion of his labor force. The argument is not that the private receipt of profits is bad, but that one, or a few, in an industrial enterprise should not enjoy profits to the exclusion of all who participate in the work of the firm. This overlooks the fact that laborers are generally hired for a stipulated wage which they receive whether the business succeeds or fails, while the owner risks his property.

This is, too, the only basis upon which many of them would, or should, take employment. In order to guarantee wages, the employer must have the chance of profit, so long as he bears the risk of loss.

In short, if profit taking by individuals is wrong the system of private property cannot be defended. Whether this system is good cannot be discussed in this chapter. The assumption, however, is that it can be successfully defended.

The Rate of Profit That Is Justifiable. — It does not follow from the above that any possible rate of profit is justifiable. To argue that the receipt of profit is necessary in order to stimulate individual initiative is not to say that the highest conceivable rate is necessary. The necessary rate is merely the rate that will induce the hazarding of property in the lines of enterprise that are desirable. Is this 7 per cent, or 10, or 15, or 25, or 100, or some higher figure? The answer would seem to be that the necessary rate will vary among enterprises depending upon the degree of hazard involved. This rate also must be an average rate over a period of years and not a rate for a single year. A very high rate of earnings in one year may be merely compensatory for the losses or low earnings of other years.

If the maximum rate necessary to enlist enterprise could be determined, then what of the amount over and above this? Should it be taken by the government in the form of an excess profits tax? Much could be said for this policy. As such a tax is to a high degree costless, as compared with other taxes, some of the present taxes could then be given up. Further, the

auxiliary problem of the concentration of wealth is also involved in this question. To lay a heavy tax upon excess profits would tend to check the accumulation of large fortunes, and this is perhaps desirable.

Following the late war, the point was repeatedly made that the excess profits tax which had been enacted during the war, and had not yet been removed, was responsible, or in part responsible, for the high prices which prevailed at that time. This charge was very largely unsound as was shown in Chapter XLVIII. Both economic analysis and the course of price during the period of the excess profits tax show the invalidity of this contention. An excess profits tax does not fall upon the marginal firms, considering industry as a whole, nor does it fall upon firms at the margin of transference to different lines of work, since it applies equally to all industries. An excess profits tax drawn so as to apply to profits over a period of years is to be desired in a well ordered system of taxation.

But in this connection it must not be forgotten that the use to which profits are put is very important. Large profits in many cases are, as stated elsewhere,[1] left in the business. The funds so used, if the business is socially desirable, are being used in the social interest. Perhaps in many cases they are being used more effectively in promoting the general welfare than would be the case if they were taken by the government. It would be possible, however, to have a tax apply in such cases, but permit the firm in question to transfer its stock or bonds to the government in lieu of money payments. This would leave the funds to be devoted to business purposes, but it would give property ownership in a share of the large profits to the government. This would permit some sharing of control on the part of the government, and would provide a yearly income to the treasury.[2]

One interesting by-product of such a tax, as our experience shows, is that certain firms would be encouraged to raise the

[1] Chapter XIII.

[2] This idea was developed by Alvin S. Johnson in the *Atlantic Monthly*, Vol. CXV, January, 1915, p. 25, "An Endowment for the State." The point was made in relation to inheritance, not excess-profits, taxation.

wages of their employees. Since the profits, if made, would have to be turned over to the government, they would in some cases be used to advance wages. This would encourage, or force, other employers to advance wages, and would thus result in a more equal distribution of wealth. This would mean a generally higher standard of living throughout our society than would otherwise prevail, and hence such a program is in the interest of social welfare.

PROBLEMS AND EXERCISES

217. Recite the details of a case from your own experience if possible in which *pure* profit was made. Show the factors responsible for this. Show that this is a case of *pure* profit.

218. Recite the details of a case, from your own experience if possible, in which a loss occurred. Show the factors responsible for the loss.

219. What is the fundamental reason for the existence of profits and losses? Under what imaginable conditions would there be neither losses nor profits — but only wages, interest, and rent — for the individuals that engage in industry?

220. "The judgment of the business manager is the big factor in determining profits or losses." Then why shouldn't profits be called wages? Why shouldn't corporations bid against each other for competent managers until the managers get as wages all that now go to stockholders as profits?

221. Try to give a case, real or imaginary, in which chance — luck — accident — alone led to the making of a big profit. That is, a case in which the judgment of the manager was not a factor at all. Explain carefully.

222. Is it justifiable that business men should make profits? Big profits? How big?

223. "Many business men save their profits." How?

224. Is the question as to the uses to which profits are put important in determining whether it is wise for the government to tax profits heavily? Explain.

225. From 1917 to 1919 the Goodyear Tire and Rubber Company made large profits, while the San Francisco Street Railway Company sustained losses. But from 1920 to 1922 the situation was exactly reversed. How would you explain this?

REFERENCES

The best book dealing with this subject is *Risk, Uncertainty, and Profit*, 1921, by F. H. Knight. See also the books listed in the appendix.

CHAPTER LVI

STATISTICS OF WEALTH AND INCOME

In the preceding five chapters, we have been concerned with the distribution of the economic income among the recipients thereof in the form of wages, interest, rent, and profit. Some slight attention was given in these chapters to the statistics of income. But for the most part the chapters had to do with analyses of the nature of each of these four kinds of income. This chapter will be largely devoted to a presentation of the statistics of the wealth and income of the people of the United States.

It should be noted in the first place that the data as to wealth and income are largely estimates. But as the many experts who have made estimates in these matters have all arrived at approximately the same conclusion, their findings may be accepted as, at least, the rough outlines of the true picture. The most recent study of this subject was made by the Federal Trade Commission in response to a resolution of the United States Senate. The commission finished its study in May, 1926.[1] This chapter is based largely upon the data given in its report.

The Wealth of the People of the United States. — The commission estimates the wealth of the people of the United States as amounting to over 353 billion dollars in December, 1922. This estimate was 32 billion dollars in excess of the census estimate for the same date. The following table sets forth the items of the census estimate together with the estimates of the commission. The higher estimate of the commission, as compared with the census, is due, as the table shows, to the inclusion of the value of streets and roads, and to additions made to the valuation placed on public service corporations.

[1] *Wealth and Income*, Senate Document No. 126, 1926, 381 pp.

TABLE 17

Census Estimate of National Wealth as of December 31, 1922, with Federal Trade Commission Extensions.[1] (Thousands of Dollars)

Item	*Census Estimates*	*Commission Estimates* [2]
Real property and improvements, taxed.[3]	$155,908,625	....
Real property and improvements, exempt	20,505,819	....
Land and improvements in streets and public roads:		
Rural public roads	....	$ 6,850,000
Streets, pavements, and public-owned underground structures in city streets.	....	13,500,000
Other highway structures not in tax-exempt item	.. ..	1,500,000
Movable equipment of farms and factories:		
Live stock	5,807,104	... ...
Farm implements and machinery	2,604,638	....
Manufacturing machinery, tools and imp.	15,783,260	. ...
Motor vehicles	4,567,407	. . .. ..
Public service enterprises:		
Railroads and their equipment	19,950,800	26,000,000
Street railways	4,877,636	7,000,000
Telegraph systems	203,896	285,000
Telephone systems	1,745,774	2,450,000
Pullman cars, etc.	545,415	700,000
Electric light and power stations privately owned	4,229,357	5,500,000
Other [4]	3,812,369	....
Products, merchandise, etc.:		
Agricultural products	5,465,796	....
Manufactured products	28,422,848	....
Imported merchandise	1,548,666	....
Mining products	730,296	....
Furniture and personal effects	39,816,001	....
Gold and silver coins and bullion	4,278,155	....
Total	$320,803,862	63,785,000
Census items unmodified	....	289,250,862
Total	$320,803,862	$353,035,826

[1] For continental United States, excluding Alaska. P. 28.

[2] Net addition to census estimate is $32,232,000.

[3] Except real estate of public service enterprises.

[4] Includes pipe lines, shipping and canals, and privately owned waterworks.

The Nature of Wealth. — It is well to note that so-called intangible wealth is not included in this table. To do so would involve double counting as explained in Chapter XLIX. Shares of stock, bonds, mortgages, notes, milk tickets, etc., are merely evidences of personal claims upon wealth or income. The organization of a corporation to buy an office building and the issuance of a thousand shares of stock does not increase the wealth of the nation. A subsequent increase in the volume of paper claims on the building will not add a cubit to the size of it, nor does the giving of a mortgage on a farm increase farm acreage, nor the checking of hats at a luncheon increase the community's stock of headgear. Babies may not be fed on milk tickets, nor may freight be transported on shares of railway stock, nor bonds used as equipment with which to generate electricity.

It is very important that we have paper claims to wealth. Our society would be much poorer without this device. It enables us to have automobile factories, gas plants, and hotels that would otherwise be impossible because of the difficulty of gathering the funds necessary for their construction. But this does not mean that in addition to these articles of national wealth, the paper claims of Tom, Dick, and Harry to a share of ownership in them are also wealth. If all of our stock, bonds, mortgages, and milk tickets should be burned up, the wealth of the world would not be less, although certain persons might not then be able to prove their claims to part of it.

One reason for the emphasis on this point is that the tax systems of most of our states, as noted in the chapter referred to, are based in part upon the notion that evidence of a claim against an article of wealth is also wealth. Stocks, bonds and mortgages are commonly taxed in addition to the articles against which they are merely personal claims. This is, clearly, double taxation.

Land Value in the National Wealth. — It is also interesting to note the position which real estate has in the total wealth of the nation and, also, the portion that is ascribed to that part of real estate which is land, that is, merely space on the

surface of the earth. The commission's estimate of this is as follows:

TABLE 18

Estimated Amounts of Wealth in Land and Improvements, 1922[1]

Total Real Estate	*Land (000,000)*	*Improvements (000,000)*	*Per Cent*	
			Land	*Improvements*
$230,411,000,000	$122,164	$108,247	53	47

TABLE 19

Estimated Amounts of Total National Wealth and Wealth in Land, 1922[1]

Total National Wealth	*Land (000,000)*	*Per Cent*	
		Land	*Improvements and All Other Wealth*
$353,035,862,000	$122,164	34.6	65.4

The title to space upon that portion of the surface of the earth that is included within our national boundaries, according to these estimates, thus represents over one-third of the total national wealth. This portion of the national wealth is not made up of produced goods. It, in a way, testifies to overcrowding and poverty rather than to wealth. If land were so abundant as to be free, the amount of wealth would be less but the amount of welfare would be greater. To further illustrate this point, if air were so scarce that a price would be paid for it, the dollar wealth of the community would be increased, if all other things remained the same, but since this would mean that some persons would not have as much of this commodity to use as they have now, the totality of welfare would be less. It is because we have so much less land per person than we would like to have, that the price of it is so high. On the other hand, of course, it is only because our nation is so rich in other things

[1] *Ibid.*, p. 34.

that it is possible for so many people to pay such high prices for land that it amounts to over one-third of our national wealth.

The Increase in Wealth from 1912 to 1922. — The Commission estimated that, measured in dollars, the wealth of the country increased by 78 per cent during the 10-year period ending in 1922. This figure represents a nominal rather than a real increase in wealth, as the value of the dollar declined considerably during this period. In other words, the price level rose during the decade under review. According to the commission, prices rose 52 per cent, as indicated by the price indexes of the Bureau of Labor. If the dollar figures of wealth increased by 78 per cent, and if 52 points of this increase were due to the increase in the price level, the real rate of increase is to be found in the percentage increase of 178 over 152. This is 17 per cent, or a rate slightly in excess of the percentage increase in the population.

"No exact significance, however, should be attached to this modification of the rate of increase in national wealth. The index used, while serviceable to correct extreme dollar changes, and probably the best one at hand for this purpose, was not devised specifically for measuring changes in value of fixed forms of wealth. Commodity price indexes are much more subject to sudden and sharp fluctuations than the value of land, buildings, installations of heavy machinery and most other kinds of durable goods, and, therefore, tend to misrepresent the changes in the dollar values of such goods." [1]

The Commission also considers the indexes of change in the physical quantities of certain goods during this 10-year period. The capacity of railway locomotives increased by 37.5 per cent; the horse power of electrical prime movers, 169.5 per cent; the kilowatt capacity of dynamos, 177.1 per cent; miles of telephone wire, 84 per cent; and the number of automobiles, 1196.4 per cent. The number of sheep declined 30.6 per cent, and the number of swine and horses 10.8 and 7.1 per cent respectively. These are the only items in the table that show a decrease during this period. The Commission observes:

"How far this result (the decline in live stock) needs to be qualified with reference to the weight of domestic animals in 10 years has not

[1] *Ibid.*, p. 51.

been computed. It should be remembered, also, that comparisons of individual years for farm animals show changes that are largely the result of year-to-year fluctuations rather than of significant trends." [1]

The Commission concludes this part of its study by saying:

"It is impossible to compute a general index of the increase in wealth for the 10 years covered by the census figures from such physical statistics as those presented above. It is possible, however, to infer that the increase in the quantity of wealth is much exaggerated by the mere dollar figures. On the other hand, this increase as modified by taking account of changes in the value of the dollar may possibly understate the real increase due to imperfections in the index, when used for this purpose. In a general way the indications of these statistics of increase in quantities of particular forms of wealth suggest the possibility of a considerably larger rate than that computed by the use of price indexes.

"In terms of the quantity of goods yielding economic satisfactions, the people of the United States did not make any very remarkable gain as between 1912 and 1922, but wealth increased, apparently at a somewhat greater rate than the rate of increase of population. Doubtless the increase would have been still greater but for the great waste in wealth caused by the war, but time has not permitted an estimate of this waste." [1]

A footnote is then added to the effect that during this period the claims of Americans on the people of foreign countries increased by some $9\frac{1}{2}$ billion dollars, exclusive of the debts which England and European countries contracted with the United States Government, which amounted to about 10 billion dollars.

The Distribution of Wealth Among Individuals. — The outstanding fact relative to the distribution of wealth ownership among the persons who comprise the population of the nation is that a very few persons own most of the wealth, and that the bulk of the population owns but very little. The data on this subject are very meager. The estimates that are accepted as being most trustworthy are those that are based on the records of probate courts showing the estates of decedents as recorded by administrators or executors of the estates of deceased persons. All items of wealth are not probated when a person possessing property dies, but estates of all sizes are settled in this manner. The probate court records thus give a cross-sec-

[1] *Ibid.*, p. 55.

tion of wealth ownership, and may be accepted as a fairly accurate representation of wealth ownership throughout the entire population.

The Federal Trade Commission in its study of wealth distribution examined the records of all of the estates probated in 24 counties, located in 13 typical states, including the District of Columbia, covering the period 1912–1923 inclusive. Data were secured on 43,512 estates. This is the most extensive examination of probate court records that has been made in a study of wealth distribution. The following table is a summary of the findings of the Commission.

TABLE 20

DISTRIBUTION OF WEALTH IN UNITED STATES AS INDICATED BY ESTATES OF 43,512 DECEDENTS IN SELECTED COUNTIES (1912–1923) [1]

Size Group	*Number of Estates*	*Value of Estates*	*Average Value*	*Per Cent of Total Estates*		*Per Cent of Total Probated Estates*	
				Number	*Value*	*Number*	*Value*
Not probated [2]...	141,446	$36,493,068	$258 [3]	76.5	5.2	. .	. . .
Under $500 ..	6,099	1,574,598	258	3.3	0.2	14.0	0.2
$500 to $1,000...	4,824	3,388,144	702	2.6	.5	11.1	.5
1,000 to 2,500.....	8,766	14,196,279	1,619	4.7	2.0	20.2	2.1
2,500 to 5,000. ..	7,572	26,933,713	3,557	4.1	3.8	17.4	4.0
5,000 to 10,000....	6,446	45,160,804	7,006	3.5	6.4	14.8	6.7
10,000 to 25,000.	5,518	85,233,637	15,446	3.0	12.0	12.7	12.7
25,000 to 50,000...	2,231	77,930,090	34,930	1.2	11.0	5.1	11.6
50,000 to 100,000.	1,105	76,040,228	68,815	.6	10.7	2.5	11.3
100,000 to 250,000.	651	97,599,624	149,922	.4	13.8	1.5	14.6
250,000 to 500,000.	179	60,325,705	337,015	.1	8.5	.4	9.0
500,000 to 1,000,000	76	52,026,811	684,563	... [4]	7.4	.2	7.8
1,000,000 and over.	44	130,913,033	2,975,296	... [4]	18.5	.1	19.5
Total probated	43,512	671,322,676	15,428			100.0	100.0
Total all estates	184,958	707,815,744	3,827	100.0	100.0		

[1] *Ibid.*, p. 58.

[2] Estimated from census mortality tables.

[3] Decedents who left no estate for probate were presumed to have had as much property as the average of the lowest group, namely, $258 each.

[4] Less than one-tenth of 1 per cent.

It will be noted that 141,446 estates that were not probated are included in the table and are estimated as representing an average of $258. These figures were arrived at in the following manner. The total number of persons dying in these counties during this period was estimated to have been 259,908. Of these, 184,958 were estimated to have been over 21 years of age. This is taken as the total number of estates. Deducting the number of probated estates, 43,512, there remain 141,446 that were not probated. The average of the probated estates in the less than $500 group was $258. This figure was assigned as the average in the unprobated group.

The table shows that slightly more than 1 per cent of the estimated number of decedents owned about 59 per cent of the total estimated wealth of all the decedents; or that less than one-four-hundredth of the total estimated number owned over one-third of the total estimated wealth of the whole group. Among the poorer groups, the table shows that slightly over 80 per cent of the estimated number of decedents owned less than 6 per cent of the estimated wealth of the entire group. The average for the group as shown by the table was $3827, but more than 91 per cent of the total estimated number had estates valued at less than this amount.

Another presentation of the data given in the table is the following:

TABLE 21

Distribution of Wealth on Basis of Table 20[1]

Economic Group	*Percentage of Total Value of Estates*
Poorest 79.8 per cent of decedents Estates under $500	5.4 per cent
Lower middle class of decedents — next 14.9 per cent Estates $500 to $10,000	12.7 per cent
Upper middle class of decedents — next 4.2 per cent Estates $10,000 to $50,000	23.0 per cent
Richest 1.1 per cent of decedents Estates over $50,000	58.9 per cent

[1] *Ibid.*, p. 61.

While these data cannot be said to show the precise division of wealth ownership throughout our population, they can unquestionably be taken as a rough approximation of the facts. They indicate that the richest 1 per cent owns about 60 per cent of the wealth of the country and that the poorest 80 per cent owns about 6 per cent of it. Even allowing for a large margin of error in the direction of concentration, the conclusion would remain that relatively few persons own almost all of the wealth of the nation.

These data are very similar to those compiled by King for 1900,[1] but they show a greater degree of concentration of ownership than do King's data. These data, too, support the conclusion of Spahr[2] in 1896, and of Hunter[3] in 1904, that 1 per cent of the population owns more wealth than do the other 99 per cent.

Estates of One Million Dollars and Over. — The Federal Trade Commission also made a study of the estates of one million dollars and over which were probated in New York City, Philadelphia, and Chicago during the six-year period, 1918 to 1923, inclusive. There were 540 such estates, with a total value of over 2 billion dollars. Of these estates 74 amounted to over 5 million dollars each, 5 to over 50 million each, and 1 was over 100 million dollars.[4] These figures give further evidence of a great concentration of ownership. The liability of such estates to a heavy inheritance tax normally results in disposing of part of the fortune by gifts before the death of the owner. Thus it is to be expected that these estates were really larger than the figures indicate. Further, this same consideration would tend to keep out of the one million-dollar group, which is here considered, estates which really amounted to this sum.

Considering these facts, and remembering that the large

[1] W. I. King, *Wealth and Income of the People of the United States*, 1915, p. 80.

[2] C. B. Spahr, *The Present Distribution of Wealth in the United States*, 2nd ed., 1896, p. 55.

[3] Hunter, *Poverty*, 1904, pp. 59–60.

[4] *Ibid.*, p. 67.

estates probated in six years tend to be a small portion of the total number of such estates, and, also, that there are many large cities in the country, other than these three, in which rich persons live, the conclusion follows that the above estimates of the concentration of wealth are very conservative. Subtracting the Commission's estimate of government-owned wealth, from the total wealth in the nation, there remains something over 300 billion dollars. The 540 estates under consideration thus amounted to 2/300 of the total privately owned wealth in the nation. In other words, an insignificant number of persons out of our population of 110,000,000, at that time, owned two-thirds of 1 per cent of the total private wealth. Not much allowance need be made for the one million dollar estates that were not probated in these three cities during the given six years, and for the million-dollar fortunes in other cities, and the somewhat lesser fortunes throughout the nation, including the three large cities, in order to reach a staggering proportion out of the 300 billion dollars of privately owned wealth.

The concentration of wealth ownership is even greater in England than it is in the United States. Chiozza-Money concluded that "a group of about 120,000 people, who with their families form about one-seventieth part of the population, owns about two-thirds of the entire accumulated wealth of the United Kingdom."[1] Data for other countries show a similarly high degree of concentration of ownership, but it is believed that in no country is this as marked as it is in England.

Is the Concentration of Wealth Increasing? — There is perhaps a much higher degree of concentration of wealth in America and in other countries where modern industry prevails than there was a century ago. The present system of industry lends itself to the amassing of large fortunes by a few persons. But it seems to be clear that the change has come not by the poorer classes getting poorer, but by the upper economic groups becoming richer. The poorer groups own as much wealth per person as they did a century ago, but they own a smaller portion of the total.

[1] Chiozza-Money, *Riches and Poverty*, 1910, p. 79.

The Statistics of Income. — The Federal Trade Commission, in the study to which frequent reference has already been made, estimated the total national income of the people of the United States to be as indicated in the following table for the years specified.

TABLE 22

ESTIMATES OF THE TOTAL ANNUAL INCOME OF THE PEOPLE OF THE UNITED STATES AND THE INCOME REPORTED IN PERSONAL INCOME-TAX RETURNS WITH INDEX NUMBERS BASED UPON 1918 AS 100 FOR THE SIX-YEAR PERIOD, 1918–1923 [1]

Year	*Estimated Total Income*		*Income Reported in Personal Income-tax Returns*		*Per Cent of Total*
	Amount	*Index Number*	*Amount*	*Index Number*	
1918	$60,223,000,000	100	$17,746,000,000	100	30
1919	67,391,000,000	112	22,438,000,000	126	33
1920	74,264,000,000	123	26,690,000,000	150	36
1921	52,607,000,000	87	23,329,000,000	131	44
1922	61,738,000,000	103	24,872,000,000	140	40
1923	69,833,000,000	116	31,107,000,000	175	45
Average	$64,343,000,000	107	$24,364,000,000	137	38

The National Bureau of Economic Research has also made careful studies in regard to the national income, and although it used slightly different methods from those of the Commission, its conclusions were practically the same as those indicated in the table above.[2] It is interesting to note the effect of the industrial depression of 1921 upon the volume of national income as shown in the table. The portion of the total income that is reported for taxation under the national income tax is put at 45 per cent for 1923. This is higher, it will be observed, than the similar percentage figures for the other years. The growth in national income during these years is estimated to have been 16 per cent.

Attention should also be directed to the figures given for 1920.

[1] *Ibid.*, p. 221. [2] *Ibid.*, p. 222.

This was a year of very high prices, and thus the unusually large income for this year is nominal rather than real. The Commission corrected the figures in the table by using the cost-of-living index of the Labor Bureau, and secured the following results.

TABLE 23[1]

NATIONAL INCOME CORRECTED FOR CHANGES IN PRICES

Year	*Original Estimate*	*Estimate of Equalized Purchasing Power*
1918	$60.2 billions	$59.0 billions
1919	67.4 "	61.3 "
1920	74.8 "	61.3 "
1921	52.6 "	50.6 "
1922	61.7 "	63.0 "
1923	69.8 "	69.8 "

According to this table, the income for 1920 in terms of the prices for 1919 was no higher than was the income for the preceding year. The 1923 income is shown to have increased considerably over that for 1922, even after allowing for changes in prices. The total national income for 1923 was approximately 70 billion dollars.

The Division of Income Between Labor and Capital. — The Commission made an investigation of the division of national income between labor and capital in the six different fields into which it classified the economic activity of the nation, and reached the following conclusions for the year 1923.

A similar study was made for each of the five preceding years. In 1918 and 1919 labor was estimated to have received 46.8 and 48.5 per cent, and in 1920 and 1921, 57.8 and 59.9 per cent of the total. In 1922, the figure was approximately the same as that for 1923.

The portion of income from agriculture that is allocated to labor is very small, as shown by the table. This is due to the fact that the labor of the farmer, whether owner or tenant, and

[1] *Ibid.*, p. 225.

TABLE 24[1]

ESTIMATES OF THE TOTAL NATIONAL INCOME AND THE SHARES OF LABOR AND CAPITAL FOR THE PRINCIPAL KINDS OF ECONOMIC ENTERPRISE, 1923

Enterprise	*Amounts in Millions*			*Per Cent*	
	Total	*Labor*	*Capital*	*Labor*	*Capital*
Agriculture	$ 9,433	$ 1,132	$ 8,301	12.0	88.0
Mining, manufacture and construction	29,372	19,194	10,178	65.3	34.7
Transportation and communication	7,444	4,859	2,585	65.3	34.7
Mercantile	8,641	5,763	2,878	66.7	33.3
Professional and personal service	11,520	4,999	6,521	43.4	56.6
Banking and miscellaneous enterprises	3,433	2,249	1,184	65.5	34.5
Total	$69,843	$38,196	$31,647	54 7	45.3

the labor of members of his family are not included in the labor category. Only that labor is included for which wages are paid out. The farmer's labor service, for the purpose of this table, is rewarded by the income which he receives as a return on capital. If the labor return in agriculture was corrected to include wages earned as well as wages paid out, the total labor return would be considerably augmented. It is to be expected that this would show labor's share in the national income to equal two-thirds of the whole, as is indicated as being the case in four of the six divisions in the table. This is very similar, it will be recalled, to the estimates of the National Bureau of Economic Research as given in Chapter LI.

The Concentration of Income. — The fact that labor's share in the total national income amounts to about two-thirds of the total shows that income is far more equally distributed than is wealth ownership. This is due, obviously, to the fact that all laborers, including salaried employees, receive an income, but many of them do not own any wealth. Despite the fact, however,

[1] *Ibid.*, p. 228.

that the income to labor represents about two-thirds of the total national income, there is a high degree of concentration. The National Bureau of Economic Research made an intensive study of the distribution of the national income for 1918 among the persons who received incomes during that year. The following table presents some of its estimates.

TABLE 25[1]

DISTRIBUTION OF INCOMES IN THE UNITED STATES IN 1918

Income Class	*Simple Distribution*		*Cumulative Percentages*	
	Number of Persons	*Amount of Income*	*Income Receivers*	*Amount of Income*
Under zero	200,000	$ 125,000,000	0.5	–.2
$0 to 500.........	1,827,554	685,287,806	5 4	1.0
500 to 1,000... .	12,530,670	9,818,678,617	38.8	17.9
1,000 to 1,500 ..	12,498,120	15,295,790,534	72.0	44.3
1,500 to 2,000	5,222,067	8,917,648,335	85.9	59.7
2,000 to 3,000 . .	3,065,024	7,314,412,994	94.1	72 3
3,000 to 5,000.....	1,383,167	5,174,090,777	97.8	81.2
5,000 to 10,000 ..	587,824	3,937,183,313	99 3	88.0
10,000 to 25,000.	192,162	2,808,290,063	99.8	92.9
25,000 to 50,000.	41,119	1,398,785,687	99.9	95.3
50,000 to 100,000..	14,011	951,529,576	99.98	96.9
100,000 to 200,000.	4,945	671,565,821	99.99	98.1
200,000 to 500,000.	1,976	575,019,200	99.99	99.1
500,000 to 1,000,000	369	220,120,399	99.99	99.5
1,000,000 and over.	152	316,319,219	100 00	100.0
Total	37,569,060	$57,954,722,341	....	.....

Thus according to the bureau's estimates almost 39 per cent of the income receivers during 1918 had incomes of less than $1000 and 72 per cent of them received less than $1500. Only approximately 14 per cent of the income receivers had incomes of $2000 or more; only 2.2 per cent were at the $5000 mark or above; and less than 1 per cent had incomes of $10,000 or more. Another table of the bureau, giving more complete data,

[1] Adapted from the National Bureau of Economic Research, *Income in the United States, Its Amount and Distribution, 1909–1919*, 1922, pp. 136–137.

shows that the number of persons having incomes of $8000 or more for this year constituted only 1 per cent of the total number. This upper 1 per cent of the income receivers got 14 per cent of the total national income.

To return to the above table, these data show that the richest 0.7 per cent of the income receivers got 12 per cent of the national income; that 2.2 per cent of the upper income group received approximately 20 per cent of the total; and that the upper 14 per cent received 40 per cent of the total income. Measuring from the bottom of the income scale, 72 per cent of the poorest income receivers had 44.3 per cent of the income, and 85.9 per cent of the poorest received approximately 60 per cent of the total income for the year under consideration.

Interesting data in regard to the distribution of income are also found in the official reports concerning the national income tax. Nearly 10,000 persons reported for taxation incomes of $100,000 or more in 1925. About half of these incomes amounted to $150,000 or more, and 786 of them were in the $500,000 or more group, and 207 were incomes of $1,000,000 or more. The corresponding figures for 1926 are approximately the same as these. The $500,000 or more group includes 693 and the $1,000,000 or more group 228.

The $1,000,000 or more income group has increased markedly in recent years. For the years 1923 and 1924, there were reported 74 and 75 incomes, respectively, of this size. The number for 1925 is thus almost three times that for either of the two preceding years, and the number for 1926 is still larger. Only 21 such incomes were reported in 1921, but there were 206 reported in 1916 when the European war was contributing to the personal enrichment of many Americans. The final figures for 1926 are not yet available (June 1928) but by August 31, 1927, 228 such incomes had been reported for 1926. This is by far the largest number for any year. It represents an increase of 21 over the preceding year, not of millionaires, but of income millionaires.

It is interesting to note the source of income as reported to the national government. The incomes of $1000 to $5000

come largely from wages and salaries. Fifty per cent or more of the total is so derived. But of the incomes of $150,000 or more for 1926 only 11 per cent of the total was received in this way. Capital gains, from the sale of property held for more than two years, were responsible for almost 45 per cent of the incomes of $1,000,000 or more in 1926, according to the official preliminary report, and dividends accounted for almost 40 per cent. Wages and salaries are credited with approximately 3 per cent of these incomes.

Income Below $1500. — It seems almost unbelievable to a person whose lot is cast in pleasant places that 72 per cent of the income receivers in the United States have incomes of $1500 or less per year. The Federal Trade Commission's report that has been frequently referred to in this chapter gives an abundance of supporting data on this point, in the form of wage data. Wages of hired agricultural workers are placed at $1356 for 1919 and at $1132 for 1923.[1] The average income of all persons engaged in agriculture was perhaps not very much above this figure. It must be remembered in this connection that almost one-third of the persons gainfully employed in the United States are engaged in agriculture. Anthracite coal miners are reported to have received wages of $1427, and bituminous coal miners, $1251, during 1919. The average wage payments to all mine and quarry wage earners for that year, including almost one million persons, are given as $1320.[2] In the field of manufacturing, the average wages paid in 1919, in fifteen branches of the industry, were $1157; in 1923, $1254. The highest wage payments in manufacturing were made in connection with transportation, and the lowest in tobacco manufacture, for each of these years. In 1923 these were, respectively, $1589 and $823.[3] There were some 8 million persons employed as wage earners in manufacturing during that year.

More than $1\frac{2}{3}$ million persons were employed by the class I railroads on an hourly basis in 1923. These persons received an average wage of $1554 for that year, but 80 per cent of the

[1] *Ibid.*, p. 249. [2] *Ibid.*, p. 257.
[3] *Ibid.*, p. 262.

number received less than $1500.[1] In the telephone industry over 290,000 employees, including officers and managers, are shown to have received an average wage of $1176 in 1922. Of this number, over 159,000 were operators,[2] and they received $871 each.

There is no escaping the conclusion that a wage, and thus an income, of more than $1500 placed one in a highly favored position in our population in 1923, and that an income of $2000 set one apart as a veritable aristocrat. These wage statistics support the findings of the national Bureau of Economic Research that only a small proportion of our income receivers, 18 per cent, had incomes about $1500 per year in 1918.

Wages have increased somewhat during the five years since 1923, as indicated in Chapter LII. Union laborers are credited with full time wages per week of 233.4 for 1926 as compared with 198.6 for 1923 (1913=100),[3] and in practically all lines there has been some advance in wages. But wages are still very low. The available data indicate that few groups earn as much as $1500 per year, although more are receiving this sum than were receiving it three or four years ago. The salutary effect of the recent increases is, however, offset to some extent by a considerable volume of unemployment at the present time — the winter of 1927–1928. The Bureau of Labor Statistics places factory employment at 92 for the fourth quarter of 1927, on a basis of 100 for 1923–1925. But the increased wage rates may rather safely be regarded as permanent, and the marked degree of unemployment as temporary. Thus, yearly rates for labor as a whole may be assumed to have increased somewhat.

Family Incomes. — It should be observed that the above figures are for individual incomes and not family incomes. Distribution of income per family would show relatively less concentration than do the figures considered above. This is due, obviously, to the fact that in the poorer groups there are usually more income receivers per family than is the case in the more well-to-do portion of the population.

[1] *Ibid.*, pp. 274–275. [3] *Ibid.*, p. 300.
[2] Bureau of Labor Statistics, Bulletin No. 439, p. 705.

Real Income *Versus* Money Income. — It must also be noted that real income is not nearly so highly concentrated in our population as is money income. The upper 1 per cent of our income receivers get title to 14 per cent of the total income, but they do not eat 14 per cent of the food, wear 14 per cent of the clothes, live in 14 per cent of the houses, nor ride in 14 per cent of the automobiles. Their real income — the consumption goods which they utilize — undoubtedly constitute a great deal less than 14 per cent of the total national consumption. The explanation of this is that the recipients of the larger incomes save a considerable portion of the amount that they receive. They turn over to laborers their titles to consumption goods and the laborers produce for them production goods. This is done by their saving money and investing it in productive enterprises. But while this mitigates somewhat the evil consequences of a high degree of concentration of wealth and income it in no way justifies marked concentration.

The question of the effect and causes of inequality and the remedies therefor will be considered in the following chapter.

PROBLEMS AND EXERCISES

226. Public roads, streets, etc., were included by the Federal Trade Commission in its estimate of national wealth but were not included in the census. Discuss this difference in treatment. Refer to Chapter XLVII.

227. "Intangible wealth is not wealth." Discuss using original illustrations.

228. (*a*) What percentage of the total value of the estates given in table 20 was made up of estates of $1,000,000 or more? Of estates of $250,000 or more? Compare these percentages with corresponding ones for the number of estates, and the number of probated estates. (*b*) What size of estate, beginning at the smallest, marks the 80 per cent point in this table measured in terms of the total estates? Measured in terms of the total value of estates?

229. What percentage of our population in 1923 was represented by the 540 estates of $1,000,000 or over? Should this be computed on the basis of families or of persons?

230. Compare the data in table 24 with those given in Chapter LI.

231. According to table 25, the poorest 72 per cent of the popula-

tion have what portion of the total income? The poorest 86 per cent? The richest 2.2 per cent? The richest 0.7 per cent?

232. Why would a table showing the distribution of a nation's income not be a good indicator of the nation's distribution of wealth?

233. Under present conditions in the United States would it be possible for each family to receive an income of $5000? Explain your answer.

234. Suggest a program which would increase the per capita wealth of the people of this country.

REFERENCES

The books and bulletins referred to in the footnotes contain a great deal of additional material on this subject. The publications of the National Bureau of Economic Research are especially valuable.

CHAPTER LVII

SOME CONSIDERATIONS OF THE PROBLEM OF INEQUALITY

The Fact of Inequality. — One of the most striking facts shown in the statistics of the preceding chapter is that there is marked inequality in the incomes and wealth ownership of different persons. One per cent of the population owns 60 per cent of the wealth and 20 per cent of the families receive 50 per cent of the national income. These figures raise the question as to whether such an unequal distribution of the nation's wealth and income is justifiable, and if not, what can be done about it.

Some Degree of Inequality Is Justifiable. — Some degree of inequality in income and, as a result of this, inequality in wealth ownership, is a necessary part of the institution of private property. The reliance upon individual initiative as a means to the placement of economic agents, which is a vital part of private property, means that economic inequality, or at least the possibility of inequality, must prevail. If instead of relying upon individual initiative, the work of each person were directed by a central organization, as in an army, or as under certain forms of communism or socialism, it would be possible for the various individuals to be given equal incomes. Or, in such a community, goods might be apportioned according to the needs of the different persons, without any reference to the work which the various persons perform. In other words, the work that is to be done in such a community may be apportioned among the workers without regard to the economic returns that they are to get. It is this that makes it possible to distribute the produce of such a community equally, or according to need, among the members thereof. But in a society that is based upon private property, the work that is done is selected

voluntarily. Thus it turns out that the returns that are to be received in wages, interest, rent, or profit will determine the lines of work that are to be selected.

This situation has been described earlier in terms of prices. Scarcity of goods or services of a certain kind leads to a high price, and calls producers into the given line of work under the promise that such work will give them larger net incomes than they can get elsewhere. It is thus by giving low incomes to persons who supply goods and services which are relatively plentiful, and high incomes to persons who supply goods and services which are relatively scarce, that productive efforts, in a society based upon private property, are directed into the production of the things that are desired by the persons who have money to spend. In short, in a society with a competitive organization such as ours, inequality, or the possibility of inequality, is necessary to the placement of productive agents.

The point relative to the possibility of inequality deserves further attention. Laborers, for example, might be so adjusted among the various lines of work that they would all receive the same wage. They might thus be properly placed according to the demands of consumers and yet be paid equally. Even so, the possibility of inequality would be present, and would be realized if most of the laborers in the lumber industry, for example, went over to the shoe-making industry, assuming that no other changes in labor placement took place. Wages would then rise in the lumber industry and fall in the shoe industry. The wages in the two fields would no longer be equal. Thus while it is conceivable that placement might be so effected in a society of private property, as to make all incomes equal, the very nature of such a system nevertheless means that the possibility of inequality is ever present. Practically, too, it is almost inconceivable that consumers' demands and the ability to satisfy them could be so adjusted in a modern society such as ours that incomes would be equal. The variation in the ability of persons mutually to serve the wants of each other quite necessarily leads to inequality in payment for services rendered.

The fact that there is this inherent tendency toward inequality in income in a modern society does not, however, warrant the conclusion that any possible degree of inequality can be justified, nor that all of the means by which inequality is fostered can be approved. These aspects of inequality will receive further consideration presently.

There is another point to be considered relative to the fundamental bases of inequality. It has been emphasized that under private property, inequality, or at least the possibility of inequality, is necessary to the placement of persons at the various tasks that consumers wish to have performed. In addition to this basis for inequality, there is another that applies to any society, that is, to a socialistic society as well as to one like ours. This is the need for inequality in order that the persons who occupy the most important positions may be able to render the best service of which they are capable. Thus in an army, entirely apart from any necessity of paying the officers more than the privates in order to stimulate the ambition of men and place them in the army according to their ability, it is important that the commanding general and the other officers should be kept fit, even at the expense of the privates. If there is not enough food, nor shelter, nor protection from the enemy's guns to serve adequately all of the persons in the army, the welfare of those who are least important to its success must, in the interest of the army, be sacrificed to the welfare of those whose well-being is the most essential to the efficient performance of its task.

Similarly, the officers in a political state, or the leaders in business affairs should, in the interest of the entire community, as a general rule, be kept in condition to give the best possible service to the projects under their control, even although some persons will thereby have fewer goods than the amount that is essential to their welfare. It is, for example, justifiable to detail a physician to the service of the President of the United States even if this means that the ills of other persons will be less fully cared for than would be the case if the physician in question were not thus removed from the general body of medi-

cal practitioners. Likewise, it is socially desirable that business men whose work involves the making of many important decisions should have sufficient income that they may have ease and relaxation during their hours of leisure, even if this means that other persons, such as manual laborers, have less of the comforts and luxuries, or even of the necessities of life than they would have if the business leaders had less. It is assumed in this analysis that the business leader is engaged in work that is socially beneficial. If this is not the case, if he is preying upon the public by manufacturing goods that are detrimental to social welfare, or by promoting the sale of spurious stocks and bonds, or in other ways performing anti-social service, it is then contrary to the public interest to increase his efficiency, or indeed to pay him anything.

This defense of inequality, with the limitation that has just been noted, does not justify inequality, for the sake of inequality. It offers a defense of unequal division only if there are not sufficient consumption goods and services to serve adequately all persons in the community. Further, it must be kept in mind that while inequality is justifiable on this ground, it is also possible that persons in positions of importance may have large incomes and use them in ways that will undermine their efficiency rather than contribute to it.

Inequality and the Accumulation of Capital. — The division of income so as to make some people rich and many people poor is often justified on the ground that such a division of income will contribute to the building of capital equipment. This point was discussed in an earlier chapter.[1] The analysis is that if some persons are very rich they can easily save large portions of their incomes and make such sums available for the use of persons who wish to construct industrial equipment for the production of consumption goods; while if the national income is divided equally, with but little inequality, such extensive savings will not be made, and thus the supply of industrial equipment will be less than it would be under conditions of marked inequality. Some writers have justified a pro-

[1] Chapter VIII, "Industrial Equipment."

tective tariff on these grounds. That is, it has been argued that since a protective tariff on manufactured goods increases the prices of such goods to consumers, and as a result increases the profits of manufacturers, it makes it possible for the manufacturers to save the money which the consumers would not have saved, if the prices of the goods sold to them had been lower.

As argued in the earlier chapter to which reference has been made, this argument looks to only one of the two necessary conditions requisite to the building of industrial equipment. In order to accumulate capital, that is, build equipment, it is as necessary that the consumption goods, that are thus made possible, be sold, as it is that money funds be made available for the building of factories and the conduct of enterprise. Poverty on the part of the masses may thus operate as an effective check to the construction of the equipment which the funds of the rich make possible.

If we assume the income of the people of a given nation to be divided, first, very unequally, so that a few people are very rich and the masses very poor, and second, so that all persons have approximately the same incomes, it is reasonable to believe that the supply of industrial equipment in use in that nation would be much greater in the second case than in the first one. The ability of most persons to spend money, under the second set of conditions, would make the use of equipment profitable and lead to the offer of a high rate of interest for money funds. The disposition of most persons to save something out of income would, in view of the high rate of interest, lead to savings which would make possible the construction of equipment. On the other hand, abject poverty on the part of the masses would make it impossible for the owners of equipment to sell the consumption goods which are the fruit of industrial equipment and enterprise. The savings of the rich under such conditions would tend to be invested abroad. This, however, is another story, which will be recounted shortly.

Consider the income distribution of the people of the United States as given in the preceding chapter. According to these

data, in 1918, 14 per cent of the total national income went to 1 per cent of the income receivers, those at the top of the income scale; while measuring from the bottom of the scale, 72 per cent of the income receivers had only $1500 or less per year. The rich group under such conditions can save easily. Indeed, for the richest 1 per cent of the income receivers to spend for consumption goods the 14 per cent of the national money income which they receive would be much more burdensome than is the saving of a large part of it. But the opportunities for the profitable employment of these funds at home are limited by the tragically low incomes of more than two-thirds of the population. Hence, some one billion dollars of our yearly national savings is invested abroad. The sum so loaned during 1927 was $1,574,960,575, according to the Department of Commerce. The figure for 1926 was $1,318,554,850.

Suppose now that the money income of the people of the United States, some 60 or 70 billion dollars per year, were more evenly divided among the income receivers. This would increase the demand for consumption goods and the prices of such goods would rise. The demand for funds with which to build equipment and carry on the production of consumption goods would then be increased, and the rate of interest would rise. Savings would thus be further encouraged. He is, indeed, a bold prophet who would contend that under such conditions the industrial equipment in use in the country would be less than it is under the conditions of marked inequality that prevail to-day.

This argument implies that the rate of interest would be higher than it is to-day if there were less inequality in income and wealth distribution. This would mean that the poorer groups would have to pay higher prices than otherwise for consumption goods, but they would have more money with which to bear the heavier charge which would prevail on account of the higher interest rate. Further, under the condition assumed, the members of the poorer groups would themselves be lenders and thus receivers of interest income.

The conclusion is then that inequality in income cannot be justified on the ground that it is only by having some persons

poor and others rich that the nation can be provided with industrial equipment.

Poverty and Work. — Somewhat similarly, it is sometimes argued that the masses must be kept in poverty in order that the work of the world may be done. If we were all rich and none poor, so the argument runs, no one would be willing to do the more onerous tasks that must be performed in any civilized community. A point similar to this was considered in the chapter, "Labor"; namely, the effect of universal education on the performance of disagreeable tasks. The conclusion reached was that there is no warrant for the belief that education will make it impossible for a people to do the work necessary for their continued existence. The counsel of despair, on the point now under consideration, is equally invalid. If some Santa Claus should permanently increase the incomes of those persons who now perform the less pleasant tasks, we should expect that they would be less willing than formerly to continue to work at the wages, and for the number of hours, to which they are accustomed. This would lead, then, to such an adjustment of wages, hours, and working conditions in these lines of employments as to make employment therein more nearly equal to employment in the positions now filled by the more well-to-do. This could certainly not be regarded as calamitous by any persons other than those who desire ease and comfort at the expense of their fellow men and women. Further, of course, the idea that only those who are in dire need will work faithfully is very fallacious.

The desire for purposeful activity is a fundamental trait; and likewise is the desire for the good will of one's fellows. Hence, social standards may be such that the application to tasks will not be dependent on the satisfaction of bodily needs. Indeed, this is the condition to-day so far as a considerable portion of our population is concerned. Men live by more than bread: hunger may be least among the drives to economic activity.

Foreign Investment. — Inequality in wealth and income among the people of a nation leads to foreign investments. The

argument in support of this proposition has been suggested above. If a few persons are very rich and the masses are very poor, the ability of the rich to save money and the inability of the poor to buy many consumption goods will at the same time tend to depress the rate of interest. If the natural resources of less well developed countries are being developed for the sale of products in the world market, the rate of interest offered for funds for such enterprises will tend to rise. It may then come about that the rate of interest that can be secured in the foreign projects will exceed the rate that can be paid for home investments. This will lead the persons who have money to loan in the given country to buy foreign bonds. As a result, the bank balances of foreigners in the one country will increase and the rate of exchange will become more favorable to them. They can then, both because of having built up bank balances through the sale of bonds and because this results in a lower rate of exchange to them, buy more goods from the nation in question and pay higher prices than would otherwise be possible. The result is, then, that the rich money lenders in the one nation buy domestic goods with their savings and trade them to foreign entrepreneurs for bonds. The nation as a whole exchanges goods — usually production goods, in such cases — for bonds, or in other words, sells goods on credit.

The usual way of accounting for such transactions is that the one nation has an abundance of capital — that it has lots of money — is very rich. Further, the implications in the writings of the observers of such phenomena is that the one nation is gaining at the expense of the foreign nations — that it is becoming a creditor nation — that the others are becoming indebted to it. The truth is something other than this, as has been noted above. The one nation is unfortunate in that the great mass of its inhabitants do not have sufficient buying power to make the use of additional equipment at home as profitable to the money lenders as is its use abroad. The nation's misfortune is, furthermore, cumulative in that its labor and resources are used to produce goods for the use or comfort of foreign peoples rather than for those at home.

There is no implication in this argument to the effect that foreign trade is disadvantageous to nations nor to the poorer groups within a nation. For if goods and services are exchanged for goods and services, the well-being of the various groups is presumably augmented by such trade. The point at issue concerns only the sale of goods and services abroad in excess of the purchases from abroad of goods and services. When this happens, which is the result of buying foreign bonds — of lending abroad — of exporting capital — the material well-being of the people as a whole is kept below what it would have been if there could have been the same volume of production without the sale of goods to foreigners in exchange for bonds.

Political Corruption. — One of the unfortunate consequences of a marked degree of economic inequality is that opportunity is thereby given to the persons of wealth to use their power or money in influencing the selection of political officers and the enactment of legislation. Political control is perhaps most frequently exercised by the control of the nominations of candidates by the major party in the locality or nation. This may take the form of merely indicating to political leaders the candidates that are "acceptable." Failure on the part of the politicians to follow such suggestions tends to result in the refusal to make campaign contributions, and in the lack of friendly interest in other projects, business as well as political, in which the political leaders might engage. The power that a rich man can exercise by the nod of his head is indeed very considerable.

The tremendous amount of money that may be used "legitimately," that is, not in buying votes, but in influencing public opinion through advertising, the publishing of articles, and the use of speakers, gives to the people of wealth an enormous power politically. The enactment of laws by the legislatures and Congress to limit the amount of money that may be spent in a campaign, and to require the publication of facts in regard to the amounts collected testifies to an appreciation by practical politicians of the power of money in a political campaign.

The chance pitting of rich men against each other in political struggles reduces the evil consequences of the activity of the

rich in politics, and any progress in the development of a vigorous sense of political morality will lessen the unwholesome influence which persons of great wealth may have in the field of politics. But when all is said, the fact remains that there is latent power of political corruption in large fortunes.

Corruption in Business. — The possible evil use of great wealth is not confined to the field of politics. Corruption may be as rampant and as pernicious in the affairs of business as it may possibly be in politics. A rival concern may be frozen out by preventing it from getting loans, or securing raw material. The officials and agents of a rival concern may be bribed, and fraud and misrepresentation may be practiced against a competitor. Such conduct is by no means characteristic of rich business men, but the more money one possesses who wishes to pursue such policies the more likely is he to succeed. Such power is one of the unfortunate consequences of marked inequality in wealth. The Federal Trade Commission and other agencies of control tend to curtail such practices, and, likewise, the development of higher ethical standards of conduct among business men is tending to place economic competition on a higher plane.

The Power of the Press. — Another very significant aspect of a high degree of wealth concentration is the power that may be exercised over the press of the country. A group of rich men, or a single rich man, may have a preponderant influence on public thought as a result of the ownership of papers and magazines. Within the past few years, the consolidations of papers and the transfer of management as a result of purchase and sale have greatly increased the power of a few persons over the press of this country. The power which a few men have to influence — or determine — public opinion is of staggering proportions. The situation is saved somewhat by the existence of many independent newspapers and magazines which are edited very courageously.

Economic Opportunity. — The distribution of the opportunities to succeed economically — to make money — tends to parallel somewhat closely the distribution of wealth and income.

If the ownership of wealth is highly concentrated in a relatively few hands, there tend to be fewer opportunities for the person of small means to succeed than would be the case if wealth were more evenly distributed. The very fact of a high concentration of ownership means that a large portion of the natural resources and the industrial equipment of a country is owned by a relatively few persons, and that these persons are relatively very rich. Further, if such control has once been secured by a few persons it can normally be retained without much difficulty.

New ventures would then tend to fall into the hands of the persons who were already rich as they would be possessed of ample funds with which to experiment, and enterprises that rivaled those in which such persons were interested could be driven out of business by the use of their extensive wealth.

The persons of unusual ability would, of course, find opportunities to rise in such a situation, but the usual person would find fewer chances to succeed than if the wealth of the country were more widely distributed.

Leisure and Culture. — Some degree of wealth concentration can be defended on the ground that it is out of the leisure that results from wealth accumulation that a considerable portion of the cultural contributions to our civilization has come. Persistent toil depletes the strength of men and takes away the vigor that is necessary for the growth of ideas. Some degree of economic ease for a few, if not for all, can thus be justified as an aid to the progress of the race. Perhaps, too, very large fortunes can be defended on this score as they may be used — and to some extent are used — to endow schools and colleges and to otherwise encourage the progress of learning.

Poverty. — Poverty is not necessarily part of wealth inequality. Wealth might be very unequally distributed and yet no one have so little as to be below the line of poverty. But if a considerable portion of a population is in poverty the advisability of the distribution of wealth can be called in question. For poverty of economic goods, means cultural poverty and cannot be defended. Poverty, further, tends to perpetuate

itself. It means that the victims are undernourished physically, and untrained mentally, and thus that they ~~are inefficient~~ and unable to earn good wages. Their wages are low because they are inefficient and they are inefficient because their wages are low.[1] Hence, where poverty prevails a portion of the wealth of the community can normally be well used in an attempt to eradicate it through assisting the poor by various forms of self-help.

Poverty in America is undoubtedly more prevalent than most educated persons believe it to be. The fact that 72 per cent of the income receivers have only about $1500 or less per year suggests that a considerable portion of the population must have far less than $1500 per year per family. The wage data given in the preceding chapter should be called to mind in this connection. In all of our cities, undernourishment for lack of proper food is said by careful observers to be the lot of many, and preventable sickness and death the inevitable result of this lack of food. The effect of low income is strikingly shown by studies of the United States Children's Bureau which show that the infant death rate varies according to the income of the father. A compilation of the Bureau's findings for eight cities is as follows:

TABLE 26

INFANT MORTALITY ACCORDING TO FATHER'S INCOME[2]

Earnings	*Infant Death Rate per 1000 Births*
Under $450 per year	168
450 – 549	134
550 – 649	118
650 – 849	108
850 – 1049	84
1050 – 1249	64
1250 and over	64

[1] Compare Chapter VI.

[2] Sixth Annual Report of the chief of the United States Children's Bureau, 1918, p. 11.

According to these data, the chance that a baby will survive is almost three times as great if the father earns over $1049 per year as it is if the father's income is below $450 per year. And the chances are almost two to one as between two babies whose fathers earn respectively over $1049 per year and between $550 and $649 per year. Poverty exacts a heavy penalty from its victims.

Ability. — One of the most fundamental causes of inequality is the differences that prevail among persons. Scarcity is vital to the economic value of persons as well as of goods. Unusual physical strength, beauty, or agility; unusual talent in music, painting, or architecture; a pronounced degree of piety, or marked ability to organize and direct the work of men, to sell goods, to choose the firms to whom loans may be made at a profit all of these and more command high prices in the market.

It must not, however, be inferred that to secure a large income because one has marked ability is to get an income legitimately. The successful pirates that used to sail the main were men of unusual ability at piracy, surely, and presumably they had abilities that would have given them great success at many other lines of endeavor. Many able business men are lineal descendants of these old sea pirates. They can sell merchandise whether it be good or bad, and whether the buyers have any need for it or not; they can loan money on exorbitant terms and foreclose mortgages without a qualm; they can ruthlessly exterminate competitors, defraud the public with sales of bogus stock, and tyrannously impose upon low-paid employees. Some of them can do this, too, with a suavity and urbanity of manner that disarms the public and almost makes their victims like the treatment they receive. This all calls for ability of a very high order — but it is the ability of the pirate not that of the servant of one's fellow men.

Business success does not necessarily depend on piratical methods. Countless persons succeed by giving an equivalent for what they get as income and wealth. But it is important to emphasize that the ascribing of a large income to the ability of the receiver of it is not to say that it is earned. Incomes to

be justified must be based on service. An income is a claim upon society for the goods and services of one's fellow men, and no one should be permitted to have a claim upon others except as he gives service in return, unless, of course, it is avowedly an income of charity as in the case of children, or adults who are not able to earn that which they must have in order to live.

Professor Carver has strikingly classified incomes into three divisions according to their source: earnings, findings, and stealings. Clearly, marked ability may be exercised in stealing, but that does not alter the method. And by stealings, Carver does not mean merely the thefts that are commonly designated. He means to include with the violations of the statutory law the violations of the higher moral law.

Findings — gifts, inheritances, windfalls, and unearned increments are legitimate in many cases, but the burden of proof should always be upon the recipient thereof. It is income in the form of earnings that is legitimate without question. A worthy ideal for a race of independent men would be that no able-bodied adult should accept an income except as he earns it; or to state in the present tense the words of St. Paul's command to the Thessalonians "if any will not work, neither shall he eat." [1]

Chance — good luck — happy accident, may result in income and, furthermore, may lead to great fortunes. Indeed, many very large fortunes may be traced to some one circumstance that permitted the individual in question to get the start that made it possible for him to become a millionaire. Chance gains are a necessary part of a progressive society. New inventions, new processes, new demands cannot but tip the scales of fortune toward certain persons, who if they are able and awake to their opportunities can hardly fail to succeed. But those who thus succeed may be not a whit more able than countless others who did not happen to "hit it lucky." Many persons, of course, are so incapable that they would not profit

[1] ". . . this we commanded you, that if any would not work, neither should he eat." Thessalonians 3 : 10.

by the most golden of opportunities, but among men who are equally able, the laws of chance favor some and not all of them. The $1000 investment of one will become $30,000,000 in twenty years, as in the case of James Couzens, who invested in Ford's infant project, but other investments that seem to be equally promising will, in considerable part, result in loss to those who undertake them. Ninety per cent of the new ventures fail, we are told, and they are not, by any means, all undertaken by fools.

Inheritance. — Another and a very important source of present day large fortunes is found in the institution of inheritance. It was estimated in 1919 that "four-fifths of the one hundred and fifty or more fortunes in the United States *having incomes of over $1,000,000* per year have been accumulating for two generations or more; and that in England where the influence of inheritance has been operating for a longer time, the number of wealthy men at the top is two and a quarter times as great, in proportion to the population, as in the United States.[1] It is very significant in this connection that five hundred fortunes of between $5,000,000 and $10,000,000 have been handed down in the United States during the present generation.[2]

It used to be said that "there are only three generations from shirt sleeves to shirt sleeves." The meaning was that one man by hard work accumulates a fortune and his son wears a coat and lives like a gentleman but wastes the inheritance, and hence the grandson of the fortune builder must work coatless. This is no longer true. Idle and incompetent sons need no longer lose their patrimony through bad management. Trust companies will manage their property for them. Further, the very multiplicity of opportunities to distribute investments over many industries, made possible by the corporate organization of enterprise, lessens the possibility that unwise investment will lead to the loss of a fortune.

[1] Irving Fisher, *American Economic Review*, March, 1919, p. 12. Quoted in Edie, *Economics: Principles and Problems*, p. 453.

[2] H. H. Klein, *Dynastic America and Those Who Own It*. Quoted in Edie, *op. cit.*, p. 455.

Another significant factor is that a fortune that is already large tends to grow in snowball fashion. A fortune that yields an income of over $1,000,000 per year, and there were over one hundred and fifty such fortunes in America in 1919, can hardly fail to grow at a tremendous rate, for the income could not well be spent. To save a large part of such an income is far easier than to spend it all. And any amount that is saved begins to earn interest and still further augments the total holdings and the income for the following year.

Programs for Lessening Inequality. — There are many schemes for lessening the inequality of wealth and income. Indeed, any proposal looking toward the eradication of poverty, or the improvement of the economic welfare of the masses, may be considered as bearing on the problem under consideration. Poverty is tied very closely in many cases with general incompetence. This suggests that one remedy is the eradication of the unfit through the process of biological sterilization. But poverty comes in part from bad luck, from improper social environment during childhood and later, and from inefficiency in the general economic organization. Provisions for reducing the amount of unemployment; improving school facilities for the very poor; raising wages at the lower levels, by legislation, trade union organization, or by the more efficient conduct of business, all tend to improve the position of the people at the lower end of the income scale.

Another factor of significance, which is in part included above, is what may be called free income. This was discussed above in the chapters on wages. The use of roads, streets, parks, libraries, and schools is all properly included as economic income to the recipients thereof, and to the poor who do not pay for their share of these things in taxes, the income is *free.* The poor do, to some extent, pay taxes indirectly in the purchases that they make, but even so, the larger part of the services enumerated is paid for by the more well-to-do element of the population. Any extension of such free income to the poor thus means some lessening of economic inequality.

One very important part of the problem of the mitigation of

gross inequalities concerns the large fortunes that were discussed above. The plan most frequently proposed in this connection is the use of inheritance taxes. This was warmly advocated some years ago by Andrew Carnegie and Theodore Roosevelt, and to-day practically all of the states have inheritance taxes and, as well, the federal government.[1] Just how high the rates should be is a moot question, but the principle that such taxes should be levied is well established in America. The principle of inheritance is, it should be noted, thoroughly defensible. It is only the inheritance of large fortunes that is socially objectionable. Such practice, as already indicated, tends to increase greatly the concentration of wealth in a few hands. And this, in turn, is detrimental to the general social interest. As Francis Bacon said over three hundred years ago, "money is like muck, not good unless it is spread."[2]

Income taxes may also be used effectively to prevent the fortunes of the very rich from accumulating as fast as would otherwise be the case. Clearly, a vigorous application of income taxes might result in the taking for government purposes such a large portion of the large incomes that only an amount sufficient for current expenses would remain. The fortunes then could not grow in size. It is claimed that the very heavy federal taxes that prevailed here shortly following the war were very effective in checking the growth of large fortunes. These taxes were, however, greatly reduced during the Harding-Coolidge administration. But whatever may be the differences in opinion relative to the tax rates that should prevail, the principle is, seemingly, well established with us that the persons with large incomes should pay higher tax rates than do the persons who receive small incomes.

The issue of taxing into the hands of the government a portion of the wealth of the rich raises the question as to the use that would be made of the wealth involved if it is left with private owners, or if it is taken by the government. Certain of the large American fortunes are undoubtedly used as effectively

[1] See Chapters XLVIII and L.

[2] *The Advancement of Learning*, Book I.

in the social interest, as if they were controlled by government agencies, if not more so. That is, the profits, interest included, that accrue to large fortunes and are used in the extension of manufacturing equipment serve the public more effectively in many instances than would be the case if such accruals were taken by the government and dispensed by the politicians. To cut down the great concentration of wealth — 1 per cent of our population owns 60 per cent of our wealth — is advisable, but to do this and direct the economic activity of the country no less wisely than it is directed now calls for wise statesmanship.

One interesting suggestion in this connection, which was referred to above,[1] is that the government should tax the rich heavily, especially by means of inheritance taxes, and use the money secured to buy stock and bonds in industrial concerns. In many cases of inheritance, this would amount to the government's taking stocks and bonds that would otherwise pass to the heirs. The control of enterprise would thus be left in private hands. The income accruing to the government from such holdings might then be reinvested in industry, or used for government purposes.

In relation to this problem of altering the present distribution of wealth and income, it is well to note that in any country property rights, whatever they are, are institutionalized. They have the permanency of character that is found in the family arrangements, or in the plan of political government, or in the beliefs and practices of the Church. In short, property rights, which are what we may call the prevailing attitudes toward the ownership of economic goods, are a social institution as is the family, state, or Church. Hence, inequality in wealth under a system of private property also becomes institutionalized.

It follows from this that marked changes in property rights seldom occur, just as marked changes in the other social institutions seldom take place. But all are subject to the immutable forces of change that permeate this world. "The mills of the gods grind slowly," but they grind.

[1] P. 495.

In the United States, property rights are perhaps more securely established than they are in any other country in the world, as noted in Chapter XXXVI. Our federal form of government, including the necessity for a written constitution to separate the state and national power, gives a high degree of permanence to the provisions governing property rights, and, further, this makes necessary the judicial interpretation of legislative acts. Thus any proposals for a change affecting property rights must not only run the gantlet of Congress or a state legislature, but must also meet the approval of the United States Supreme Court. The mere fact of an appeal from the legislative body to another body would tend toward the maintenance of the *status quo*, but with the second body being the judiciary, the curb upon change is greatly augmented, because law judges are very conservative. This point was raised frequently, it will be recalled, in the chapters dealing with the regulation of business enterprises and labor legislation. But as just stated, changes do take place. This is indicated by our present laws in respect to income and inheritance taxation. However, to repeat, property rights as they prevail at any one time have an unusually high degree of security in this country.

It seems to be reasonably safe to make the prediction that the gradual extension of learning among the masses will lead to a greater insistence upon economic democracy, and that this will take the form in part of a movement toward a lessening of extreme inequalities in the wealth and income of the people of the nation. Just what method may be used is problematical. That is on the knees of the gods.

PROBLEMS AND EXERCISES

235. Is there a close relation between social and political welfare and the distribution of wealth? Discuss.

236. Name at least three causes that account for the present unequal distribution of wealth. (*a*) Describe them in brief detail. (*b*) Do you think that the unequal distribution arising out of them is justifiable or not?

237. "Were it not for the Fords, the Morgans, the Duponts, the

Mellons, and other men of great wealth the United States would be poor in industrial equipment." Carefully evaluate this statement.

238. "Since Aristotle's time political scientists have noted a close correlation between economic power (wealth) and political power." Do you believe such a close relationship to exist? Carefully explain and illustrate your answer.

239. Why, in a democracy, does extreme concentration of wealth often tend to foster political corruption? Discuss carefully.

240. In what way is a defense of a protective tariff based upon a certain conception of the value of unequal distribution of wealth? Criticize this defense.

241. Bernard Shaw has at times suggested the advisability of an arithmetically equal distribution of income. (*a*) Do you think this would be possible under any system of government? Discuss. (*b*) Do you think such an equal distribution would be permanent? Why or why not? (*c*) Is an equal distribution of income theoretically possible in a competitive society such as ours? Why or why not?

242. Which is the more unequally divided in this country, wealth or income? Why?

243. Can both the standard of living and the degree of inequality of wealth increase at the same time? Explain.

244. What would be the effect of increased education upon: (*a*) The relative equality of income among persons? Why? (*b*) The relative equality of the amounts of property owned by property owners? Why? (*c*) Would the effect of a careful eugenics program be the same as that of an increase in the amount of education? Why or why not?

CHAPTER LVIII

A SUMMARY CONSIDERATION OF PRICES

The subject of price as was emphasized in the early pages of Volume I lies at the center of the science of economics. In further illustration of this point it will be recalled that most of the topics which have been considered in the preceding chapters concern the matter of price. The subject of money and banking, business cycles, international trade, public utilities, labor organizations, and foreign exchange, for example, bulk large with the question of pricing. And the shares of distribution, which have recently been considered, are, obviously, prices. These prices — the incomes of individuals — closely affect the prices of commodities. The problems of these relationships will be discussed in this chapter with a view to ascertaining the basic principles of pricing.

Summary of Preceding Discussions. — Before considering this question, the discussion in the earlier chapters referring to price will be summarized. Broadly speaking, it is the pricing mechanism that gives direction to the economic forces. As prices rise in one field relatively to other fields, the productive forces are drawn to the one line of work and away from the others. This comes about because of the desire of men to make profits, and this depends in part upon the necessity of making profit, in many cases, if bankruptcy is to be avoided. In short, placement is largely effected by means of pricing.

To some extent, considerations other than the desire for profit determine the choice of fields of work, and even within the different "fields," non-monetary considerations may *place* the economic agents. But by far the dominant feature in the direction of the economic actions of men to-day is the pricing mechanism. Control is largely exercised by prices.

These prices are determined in part by the free play of the desires of individuals for certain goods, rather than for other goods, but to some extent social custom and also deliberate action by groups of persons, determine the prices that shall prevail in the various lines of activity. But however they become what they are, the prices that prevail very largely control the allocation of economic effort.

Control by means of prices is not limited to a system of private property such as prevails with us. Even in a communistic organization it would be necessary to ascribe prices to finished products and to the means of production, including labor and "waiting," and to keep cost records, if the society were at all complex, and if it were desired to pay attention to the efficient conduct of economic activity. To be sure, a small communistic society in which the work that is carried on is very simple, prices may not be used at all. Such a case is analogous to that of an isolated family which is entirely self-dependent. But complexity of organization would make it necessary for a communistic society to keep books in terms to prices in order that the work of the community might be intelligently directed. Further, there can be no question of the importance of careful pricing and cost-keeping in a system of state socialism. By such a system is meant the ownership and direction of enterprises by the state, and the payment of wages to all workers and the sale of finished products to them. Careful pricing would be imperative in such a society.

It may also be noted that in cases of state or municipal ownership to-day, prices — costs — need to be accurately kept in order that the value of the products may be compared with the costs, and the undertakings with other undertakings. In sum, evaluations through the instrumentality of prices are necessary to the rational conduct of economic life.

The discussion in the preceding paragraphs has been concerned with the question of the relation between the prices of various commodities and services, and it is this question, particularly in regard to the shares in distribution, that is the subject matter of this chapter. In order to emphasize

this point, it may be noted that we are not concerned here with the relation of money to price. That is, the level of prices is not under consideration in this place. This is a question of great moment, as has been indicated earlier. This matter was given special consideration in Chapter XXXI, and cannot be further considered now. Suffice it to say that this is one of the most challenging problems to citizenship.

The most fundamental fact in regard to prices is that they are interdependent. The price of one commodity depends on the prices of other commodities, as implied in earlier chapters. Is this true throughout the system of prices? Are price relationships wholly circular? Especially, are the prices for labor, waiting, and risk-taking fundamental? Do they break the circuity in the price system? Are the wages, the rate of interest, and the rate of profit for which men will engage in economic activities primary? Are these prices determined first and the prices of commodities based on them? Are prices high or low because the wages, interest, and the rate of profit which men require as payment for engaging in economic activity are high or low? Or is it the other way about? Are the prices of finished consumable goods primary? Are these determined first and then through them the prices of the "factors" of production? Or is neither group primary? Are the two interdependent?

The Distributive Shares. — The economic product is obviously limited by the hours of work per week. If men were content to do more work, instead of stopping to play, output would be larger and prices would be altered. Relative prices of produced commodities might remain much as now, but the relative prices of produced commodities and of land, for example, would change. But it does not follow from this that wages are primary to the prices of commodities in the pricing process. In so far as wages equal marginal disutility — in so far as the particular wages that prevail are necessary to call out the amount of work that is expended — there is a mutual cause and effect relationship between prices of commodities and wages. But as argued in Chapter LII, the dis-

utility analysis has but little validity in respect to wages. Hours per day or per week are largely conventional — they are but to a very minor degree the result of carefully balancing the pleasure of having the product against the pain of work. To the extent that the disutility analysis is valid the causal relationship between prices of products and wages is one of mutuality, but to the extent that it is not, causal relationship runs from prices of commodities to wages. It is the second of these conditions that prevails generally.

Principally the prices of products are primary. What will be paid for finished goods determines what can be paid for labor service. Or to leave the employer out of the reckoning, the price that can be secured for the product is the reward of the laborer. Wages come from product.

But the prices of individual products come from wages. If attention is directed to the wages of any one group, they appear to be the results of other wages. All are bound together, and here again social custom is important. The wages of one group may be above or below the wages of other groups for no better reason than that such differentiation is accepted as reasonable by all the parties concerned. But such wage differences do not mean lack of relationship among wages. However, if the wages of a group are given, they become directly causal in the pricing of the particular commodity that is produced. An entrepreneur largely takes the wages as he finds them and sets the prices upon his product accordingly. Thus the price of any one product is a direct result of wages as a cost of production. The most primary relationship begins with the prices of finished product taken as a whole, and runs to wages, and then individual wages in turn are causal in setting particular prices. Further, wages as a whole are a large element in the demand for goods, and for this reason also are causal in the pricing process.

The above analysis has, for the sake of simplicity, been stated in terms of wages. There are, of course, other factors than labor in the economic process. But the price relations for the other factors are similar to those indicated for labor.

The waiting which is necessary in an economic society, and for which a rate of interest is paid, is clearly analogous to labor service in the pricing mechanism. The disutility analysis is perhaps more valid here than in the case of wages, as was argued in Chapter LIII. Savings would perhaps be somewhat less at lower rates of interest, because of the savings dispositions of individuals, but perhaps far more, a low rate of interest would reduce savings by reducing the income of interest receivers. Savings are a function of income as well as of the rate of interest, and the income of savers is largely derived as a result of the rate of interest and of other prices.

The rate of interest is thus not primary in the pricing process. We cannot begin with it in explaining prices. Rather we begin with prices, as in the case of wages. But here, too, the rate of interest is causal in respect to the prices of individual products. And, also, to some extent the rate of interest is causal in that it overcomes the disutility of marginal savers, and gives a volume of savings that is at least slightly different from the volume that would otherwise prevail.

Likewise, the rendering of entrepreneurial service may be thought of in terms of disutility. It is irksome to take risks, we have been told, and the pain of venturing money can be overcome only by a reward in the form of profits. But in this case as in the others, the disutility analysis is of but little validity. The venturing of money in enterprise is perhaps but little related to the expected rate of return. Investment in one line is, of course, determined by the prospective rate of return there, as compared with the prospective rates of return elsewhere. And whether one individual invests, or saves and loans to an investor, depends somewhat on the probable relative returns to him from the two processes. But investing or saving versus spending is but little affected by the prospective rate of return.

The opportunities to invest as a result of the prices that prevail are very important here, and also the custom of one's group. The disinclination to invest is not primary in the

pricing process, save to a very minor degree. Largely the causal relations run from prices as a whole to business profits, rather than from a required rate of profit to prices.

Land, or natural resources, the other basic factor in the production of goods, does not involve at all the disutility element which has been discussed in relation to the other three factors. Its price — its rent — cannot then be said to be at all primary. There is no pain or disinclination to be overcome so far as land is concerned. Thus the price of land — its rent — has from the early days of the science of economics been held to be a result of other prices and not a cause of them. This is sound enough if the question is viewed very broadly. But with prices generally as they are and with the rent of any parcel of land as it is, the rent becomes causal so far as other uses of the land are concerned. The case is analogous to that of wages. The wage in any new employment depends upon current wages, but the price of the product in the new line of work must cover the wages, else the work cannot be undertaken. The wages are a cost, although, of course, the price of the product may greatly exceed the cost. The wage is causal only in that the price of the product must at least equal the wages paid. Similarly, the rent that must be paid to get the use of a parcel of land is causal in the pricing of the product. The price of the product must at least equal the rent paid in addition to the other costs, or the work cannot be carried on.

The general conclusion, then, is that the prices of the factors of production are not independent in the pricing process. They are not primary. In the case of three of them, disutilities may have to be overcome, but whether the disutility element be included or excluded, the entire system of prices is one of interdependence. The prices of commodities and of the factors in production are mutually dependent, as was argued earlier in respect to commodity prices.

The following jingle from Davenport's *Economics of Enterprise* emphasizes this highly important feature of the pricing system.

The price of pig
Is something big;
Because its corn, you'll understand,
Is high-priced, too;
Because it grew
Upon the high-priced farming land.

If you'd know why
That land is high,
Consider this: its price is big
Because it pays
Thereon to raise
The costly corn, the high-priced pig![1]

Competition. — In view of the preceding discussion it is perhaps well to emphasize again a point that was frequently stressed in the earlier chapters; namely, the importance of the principle of competition. To say that prices are interdependent is to say that competition prevails throughout the economic system. This does not mean that there is what economists have often called free competition. Competition is not perfect. There is not a delicate balancing of supply against demand in the markets for the various goods and services. On the contrary, there are many dikes on both the demand and the supply side. In the case of some commodities and services these dikes are on the side of supply. Understandings and agreements among professional men, manufacturers, retailers, money lenders, and wage-earners as to the charges that should be made for services or products are all illustrative of the restrictive forces that operate on the side of supply. And also, entirely aside from agreements, restrictions on price from the supply side are in part social customs. Certain prices prevail because they have been accepted as reasonable. The sellers in such cases, whether they sell services or goods, would feel outraged if asked to sell below the customary figures.

And, in the case of some prices, dikes are found on the demand side. There may be understandings or agreement among buyers that they are not to bid above certain figures. This is especially likely to be the case in the employment of

[1] H. J. Davenport, *Economics of Enterprise*, 1913, p. 107.

labor, in the borrowing of money by banks, and in the purchase of raw material by manufacturers who buy in a local market. Also, the fact of custom is of importance here. Retailers often find it difficult to alter a price that has prevailed for some time, landlords experience difficulty in raising rents that have been long unchanged, and the fact of custom operates as a check upon the demand of employers when conditions tend to force wages either up or down.

But after making due allowance for the restrictions upon the price making processes that prevent a high degree of delicate adjustments from being made with every change in the economic winds, the fact remains that the forces of competition are of fundamental importance. To understand the price mechanism one must look primarily to the competitive aspect of our economic life. This is the basic determinant. But to see the picture whole, the restrictions upon the free play of competition must be observed.

Substitutions. — The principal point that has been emphasized in the above portions of this chapter is frequently phrased in terms of substitution of the factors of production for each other. Professor Cassel, a noted Swedish economist makes much of this.[1] Clearly, all competition is merely a process of substitution. Hence, there can be no question as to the general validity of the idea of substitution. But certain reservations are necessary relative to the substitution of one of the factors of production for another. Cassel points, for example, to the substitution of labor and material for land in the case of building a subway. Similarly, he describes intensive farming as the substitution of labor and material for land. Rather than use more land for surface cars, the subway is constructed, and rather than seek additional farming land, the given land is used intensively. These are cases of substitution so far as the business men directly interested are concerned. The men who are in the business of providing transportation service might buy additional land and construct more surface lines. But this land may be so high in price that it will be more

[1] G. Cassel, *A Theory of Social Economy.*

profitable to construct an underground railway. Likewise a farmer possessed of land might find it more profitable to push it far down into the stage of diminishing returns rather than purchase additional land and farm at the point of optimum returns per unit of labor and capital.

From the point of view of the entrepreneur these are cases of substitution, and they are typical of the cases that are of daily occurrence. But from the point of view of the society as a whole they cannot properly be regarded as instances of substitution. Assume a socialist state that is confronted with the problem of transportation in large cities. If it is decided to build a subway, this may be phrased in terms of the most effective utilization of the labor force. Rather than use labor in other ways it may be deemed advisable to use it in procuring the necessary materials and in building the subway. Such work would be regarded as the best possible utilization of that amount of labor. The products that are forgone in order to build the subway are the things for which it is really substituted.

Similarly, broadly speaking, machinery is not substituted for labor. Individual employers constantly do this, but so far as the society as a whole is concerned the labor force is merely re-directed when machinery is produced and used. Certainly, if unemployment does not result there cannot be said to have been a substitution of machinery for labor. The basic economic problem in any society is that of using most effectively the labor and the natural resources that are available. There is fundamentally no problem of substituting labor and resources for each other, or equipment for either. Individual business men do this but the society as a whole does not. Substitutions are constantly being made, by the entire social group, but these are in the form of one possible product for another. This is the ever present problem of choice. And another term for the exercise of choice is competition.

The Best Use of Resources. — It is frequently argued that the pricing system leads to the best possible use of the economic resources. The argument is that under the pressure of

competition a single price tends to prevail for each product. Steel, for example, tends to command the same price from all users. If steel bars sell for $1.90, then they must be put to at least a $1.90 use. Steel will not be used where a cheaper material would do as well. Or if the wages of common labor are sixty cents per hour, this price must be paid by all employers. Labor cannot be put to less than a sixty cent use. But nothing in this would prevent employers from putting labor to the best possible use above this rate. This is also true so far as commodities are concerned. The price prevents any commodity or service from being used for any less use than the price indicates, but permits any higher use. Hence the argument is that the pricing system leads to the best possible utilization of the economic resources of a community.

But the above conclusion is unwarranted. It implies an ideal distribution of buying power and a wise expenditure of that buying power. To consider the second of these first, no one who reflects upon the choices that are made in the expenditure of money could insist that the resources of a nation are put to the best possible use. There are too many spurious articles on the market, and too many persons engaged in forms of personal activity that do not promote economic welfare, for this to be true. The present method of directing economic activity undoubtedly gives a better direction to this activity than would a system of complete social control, such as communism, as is argued later in this book. But the better of two methods in this imperfect world does not give perfection. The free choice of individuals tempered however much with social control does not lead to the best possible use of economic activity.

Further, the lack of perfection in making expenditures means that certain persons come into the possession of purchasing power without having rendered social service in exchange for it. Then, too, by findings and stealings purchasing power is secured without any attempt at the giving of an equivalent to the society against which these claims run. However wisely these persons may spend the money which they thus secure,

REFERENCES

For a very keen analysis of fundamental price relationships see chapter "The Final Determination of Prices" in Taylor, *The Principles of Economics.* The two books from Cassel and Davenport to which reference is made in the footnotes above give considerable attention to the problem of ultimate price determination.

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PART X

A CRITIQUE OF THE PRESENT ECONOMIC ORDER

CHAPTER LIX

A CRITIQUE OF THE PRESENT ECONOMIC ORDER

The Moral Judgments of Economists. — In the preceding chapters various aspects of our economic system have been described, and moral judgments have been pronounced in regard to some of them. That is, certain aspects of the economic system have been approved and others have been condemned. Taxation according to ability to pay was approved as the proper criterion for the assessment of taxes. The general functions performed by trade associations and trade unions were also approved. The practice of our railway managers before they were subject to strict control was shown to have been undesirable. A relatively low degree of inequality in ownership was held to be desirable as compared with a relatively high degree of inequality. And the issuance of large quantities of irredeemable paper money, such as has taken place at certain times in our history, was condemned. These are only a few of the many illustrations that could be given of the moral judgments that have been made in the preceding pages of this book. Obviously, the word *moral* has a much broader meaning in this paragraph than it has in ordinary popular usage. Here it means a judgment in regard to that which is desirable.

Judgments such as were indicated are commonly made by economists. Indeed, there is perhaps no economist who does not make such judgments. Many of them insist, however, that an economist must only describe conditions — that he must not make moral judgments. But despite these professions by certain economists that moral judgments should not be made, and the promises that moral judgments will not be made by them, they go blithely on and approve the gold standard, condemn a protective tariff, justify labor legislation, denounce the

general property tax, and in like manner express approval and disapproval of various features of the economic system.

Economists cannot well avoid making such judgments. They come to have a vital interest in the various questions which they study, and cannot but conclude that some arrangements work well and others ill, and that certain proposed changes would be desirable and others undesirable. Further, since the economist presumably knows more about the economic system than any other specialist — more about the way the various parts function and the relation of the parts to each other — he almost necessarily comes to feel that he has a solemn duty to society to express approval and disapproval in regard to questions of economic arrangement. For an economist to refuse to recommend a procedure in regard to economic affairs would be as marked a case of professional emasculation as would be the refusal of a physician to recommend treatment for a sick child.

But, of course, an economist in his investigations must not let his hopes and fears influence his conclusions. He must, in pursuing his subject, be concerned only with ascertaining the truth. As Pigou says, in the introduction to his little book, *Unemployment:*

> "Resentment at the evils investigated must be controlled, lest it militate against scientific exactitude in our study of their causes. Pity however sincere and grief however real are here intruders to be driven ruthlessly away. Stirred by their appeal we have entered the temple of science. Against them its doors are closed, and they must wait without for our return." [1]

This high ideal of the scientist is not always realized in the work of economists, nor in the work of other specialists. Human frailty is such that cold objectivity in thinking is difficult to attain. Hopes, prejudices, presuppositions, inclinations, can only with difficulty be kept out of analyses in regard to economic or other social conduct. It is easily possible for two well-trained men to reach opposite conclusions on the basis of the same data. As a result of the way one of them has been conditioned, the data may be interpreted to mean one thing, while

[1] P. 11.

the conditioning of the other leads him to form a different conclusion.[1] This point was developed in the first chapter of Volume I of this book. To repeat the statement made there, bias and prejudice, so far as is possible, should be guarded against in all analyses.

But the fact that analysis in economics, or in any other science, should be purely critical does not lead to the conclusion that the economist, as a result of his investigations, cannot make judgments as to the light that the analysis throws on the question of the desirability or undesirability of certain policies. In fact, if analysis in economics is not to furnish a guide to social policy it becomes only a mental exercise. That, of course, may be worth while. Such activity might be justified as the pursuit of truth for truth's sake. Seldom, however, can the ascertainment of truth be an end in itself. Almost necessarily newly ascertained truth in regard to men becomes a guide to conduct. Economists, even if they so desired, could hardly prevent the truth which they find from playing some part in the direction of social life, albeit the influence of many of their findings is pitifully small, because of the self-interest of certain powerful groups and the ignorance of other groups.

Many school men would, formally, take exception to the above presentation. They would insist that the scientist must not be an advocate. His duty, it would be argued, is to analyze the situation, and, so far as there are alternative policies, present the case for and against each one without drawing a conclusion as to which is preferable. There can be no question that in many cases this is the proper course. The result of critical analysis may reveal such an even balancing of the pro's and con's in regard to a given policy that it is not apparent which line of conduct would contribute most to the general social interest. The scientist in such a case can well refrain from making any moral judgment in regard to the question at issue. That is, he can well refrain from making a recommendation as to the line of social conduct which is preferable.

[1] For an illustration see H. G. Brown, "The Single-Tax Complex," *Journal of Political Economy*, April, 1924, Vol. XXXII, p. 164.

In many cases, however, it is very puerile for the scientific economist to refuse to draw a conclusion in regard to the moral validity of a given policy. Consider, for example, the matter of regulation of railroads by the Interstate Commerce Commission, which draws its authority from the national government. The most cursory investigation of the history of railway operation indicates the imperative need of social control over the railway industry. For the economist to present the facts and refuse to make a moral judgment in regard to the question of regulation would be comparable to a physician's presenting data to show that a certain diet will contribute to the health of children, but refusing to make any recommendation as to how children should actually be fed. Indeed, the analysis in this and many other cases points inescapably to a conclusion in regard to social policy. The conclusion, as a result of the analysis, is itself a recommendation. It amounts to a moral judgment as to what is desirable.

The moral judgments of an economist are made only on the basis of certain assumptions. Indeed, any moral judgment is posited upon certain assumptions as to what is good. In other words, a moral judgment is merely a judgment as to how to realize a certain end. The end is often undefined, but it is always involved in the judgment. To say that a thing is good necessarily means that it is good for something. Good always means *good for* and bad always means *bad for*. For example, truth is good, not in itself, but because it is only on the basis of truth that men can depend on each other, and conduct themselves in a way that will develop that degree of social cohesion that is regarded as desirable in the life of the race. If the promises of men could not be relied upon, our highly interdependent economic system would be impossible. Thus if social cohesion is good, truth which is essential to it is also good. The physician's judgments as to what is good, to which references have been made above, are all posited upon the assumption that the preservation of human life is good. In short, any judgment that a given policy is good is merely a judgment that the policy in question is good for — will con-

tribute to — the realization of a given end. Assumptions as to ends are thus necessary to the formation of moral judgments.

The assumptions that are implicit in most of the judgments of economists are those which are generally accepted in our present society as to what is desirable in respect to economic relationships. These may be broadly classified into two assumptions. First, it is generally assumed that material welfare is desirable: that food, clothing, shelter, books, music, pictures, and automobiles contribute to the enrichment of life. This assumption involves a limitation upon itself, as is true of almost any general proposition. The addition of goods at the expense of health is not approved, nor is approval given to the addition of material wealth at the sacrifice of the social virtues, such as fair treatment of others. But within these limitations, the current assumption in our society is that material welfare is good.

Two corollaries follow from this assumption. First, since economic welfare is desirable, the application of economic activity so as to secure the largest possible gain with a given expenditure of energy is desirable. This may be briefly designated as an assumption that efficiency in economic activity is desirable. The antithesis of this is that waste in the production or utilization of material goods is undesirable. Efficiency, however, is approved only within limits. That is, a degree of economic efficiency that impairs bodily health or that otherwise detracts from what is generally regarded to be a "good life" is not approved.

A second corollary to the assumption under consideration is that leisure is desirable. This has already been implied in the discussion above to the effect that the principle of the desirability of material welfare is applicable only within limits. This idea is given practical form in the common acceptance in any community, at any time, that it is undesirable to work more than a certain number of hours per day. At one time ten hours per day were approved; to-day social approval runs in the terms of an eight hour day and a forty-four hour week, and, sometime in the future, approval may be given to a further shortening

of the number of working hours. Whatever number of hours may be specified, the fact of such social conventions means the acceptance of the assumption that material welfare is to be augmented at the expense of only a given number of hours of work.

The second general assumption which is commonly accepted throughout our system is that there should be a relatively high degree of democracy so far as our economic relationships are concerned. One phrasing for this is that material well-being should prevail throughout our economic system. Another phrasing for this is that each person should be considered as an end in himself rather than merely as a means toward the welfare of another. A striking antithesis of the ideal under discussion is found in the institution of slavery, which is, presumably, solely in the interest of the slave owner. The ideal of democracy in material welfare is also subject to limitations, as is the assumption which has already been considered. That is, democracy in respect to the enjoyment of economic income is defended only in so far as the principle involved does not lead to a lessening of the material welfare of the entire society. Another phrasing for this is that the extension of the democratic ideal in economic ownership and enjoyment of income is not approved beyond the point that would result in the curtailment of economic progress; nor beyond the point that would result in a weakening of the strength of the nation, thus making it less able to cope with other nations in the struggle for existence. But within these limits, the ideal of democracy is part of the common assumptions in our society as to what is good.

The democratic ideal does not call for absolute equality of ownership. For reasons which were suggested in Chapter LVI, a system of private property, such as prevails with us, requires as part of its mechanism that there shall be at least a possibility of inequality. Further, it is to be expected that there will be inequality in a private property society. The demands of buyers could hardly be such in relation to the labor services and goods which various persons have to sell that equal incomes could result. It is thus only within broad limits that the

democratic ideal in wealth ownership and income distribution is defended with us. But as between a high degree of economic inequality and a low degree of economic inequality, the general presumption is in favor of the former rather than the latter.

Another phase of this matter relates to democracy in economic opportunity. The accepted doctrine among us is that persons in the lower economic groups should be free to rise into the higher economic groups: that the channels of opportunity should be open to all regardless of social station.

It is on the basis of these two assumptions that economists commonly make judgments as to what is desirable in our economic society. Granted these or other assumptions as to the ends that should be realized in the economic society, the economist is presumably the one who is best qualified to determine the lines of conduct that will lead to the fullest possible realization of the kind of society that is desired. But the economist, as an economist, is limited in his judgment to questions that are posited upon assumptions as to the desired kind of economic society. As an economist he can judge as to whether a program of economic conduct is consistent with the end that is desired, but he has no judgment as to the validity of the end that is posited. For example, the economist, as an economist, can have no judgment whatever on the question as to whether the ascetic ideal of the early Christians is better or worse than the ideal of an ever-increasing material welfare, which prevails with us to-day. Such a question is beyond the scope of the economist. To put this matter in another way, the economist, as an economist, has no judgment as to what is ultimately good. As a man who chooses to be his own philosopher, he may have very pronounced ideas in regard to such matters. But in this realm, he is not functioning as an economist. Granted, however, assumptions such as were indicated above, the economist cannot fail to be able to express judgment as to what conditions will permit us to realize most fully the kind of economic society that is considered to be desirable.

Critics of the Present Society. — The present economic society is subject to a great deal of criticism. The very com-

plexity of the society makes it almost inevitable that many persons should be displeased with one or more aspects of it. The temperament, aspirations, and general outlook of men are so different that it would be strange indeed if many were not dissatisfied with some of the many aspects of a complex economic system.

The critics of the present system may be divided roughly into two groups; namely, radicals and liberals. In antithesis to these two groups, the defenders of the system are commonly known as conservatives. The radicals, as the name suggests, are those persons who wish to bring about fundamental or radical changes in the organization of our economic society. Since the most fundamental aspect of our present society is the institution of private property, we designate as radicals those persons who are anxious to do away with private ownership and to substitute for it some form of social or collective ownership. We also classify as radicals the persons who do not wish to abolish private property yet are anxious to effect marked changes. But, however wide the group of radicals is, the most radical are those who wish to eliminate the institution of private property. The persons holding to this view may be classified into at least three groups: socialists, communists, and anarchists. The group of socialists may be still further subdivided into many different groups as will be indicated in the following chapter.

Liberals. — The critics of the present economic system who do not wish to bring about radical or fundamental changes therein are commonly known as liberals. They occupy the middle of the road between the radical critics on the one hand and the stanch conservative defenders on the other. Persons who call themselves liberals usually profess an openness of mind in regard to problems of economic and social reform. The fact that they hold a compromise position is some evidence that they are open-minded.

Conservatives. — The conservatives are the group that defend the present system of private property, and the arrangements that prevail within it. While most of them would readily

agree that the present system is not perfect in all of its details, still they are stanch defenders of the system as a whole, and are generally strongly opposed to any change, especially in the direction of a greater degree of economic democracy.

The Criticisms of the Present System. — The criticisms of the present system may be grouped under two heads: (1) the system results in great waste and (2) a high degree of injustice prevails. These two lines of criticism, it will be noted, are in accord with the two basic assumptions in regard to the marks of a good economic society, which were developed above. Criticisms of the society on the score of its wastefulness may be divided into two divisions. First, it is claimed that a competitive system is in itself wasteful, and second, that there is marked stupidity on the part of the persons who are exercising control.

The first of these criticisms may be again divided into several separate counts. One of these is the common complaint that competition results in an unwise duplication of effort. A favorite illustration of this is the usual method of delivering milk. In a typical city there is a great duplication of effort in this way. Several different wagons drive over the same streets serving every fourth or fifth householder. In contrast with this, the delivery of mail by the national government is offered by the critics as an illustration of the greater degree of economy that could be secured if the milk business were handled by the government as is the business of delivering mail. Many other illustrations of similar waste from a duplication of effort, could be quoted from the critics. Rather than have as many stores as now exist, we are told that economies could be secured by receiving this service from a smaller number. Similarly in the field of manufacture, it is said that the factories of the country could produce a much larger quantity of goods than is now turned out. In other words, that industrial equipment has been built beyond the need for it. This point was discussed in an earlier chapter.

A second line of criticism against the present society so far as the efficient conduct of our economic life is concerned has

to do with the effort which is expended in advertising. Many critics insist that all of the economic effort which is involved in advertising might be much better applied in the further production of goods. The advertising bill in a country such as the United States reaches vast proportions. It indicates that a tremendous amount of labor and materials is used each year in this way. The critics who are under consideration insist that this economic energy is being used unwisely to-day.

In the third place, critics point out that the present economic society is very inefficient because of the lack of coördination which prevails from time to time among the different parts of the system. They make much of the fact that a considerable degree of unemployment prevails normally, and that from time to time, during periods of so-called industrial depressions, the volume of unemployment is very great indeed. Not only, of course, is there unemployment of labor during the periods of industrial depression, but also industrial equipment of various kinds is standing idle at such times. Our system, say critics, can be convicted of great inefficiency on this score alone.

Another line of criticism, from the point of view of efficiency in the conduct of economic activity, is to the effect that goods are produced for profit and not for use. In other words, that goods are made to sell. The implication is that the profit motive leads to the production of certain goods when other goods should have been produced, or to the production of goods of poor quality when goods of better quality should have been forthcoming. This, say the critics, is indicative of inefficiency.

The second line of criticism noted above relative to the efficiency of the present system is that many of the persons who are in charge of industrial enterprises do not operate them efficiently. Conclusions such as were reached by the committee of engineers, as noted in the chapter, "Industrial Management," are roundly emphasized. These conclusions were, it will be recalled, that American industry is far less efficient than the casual observer would have supposed. And the blame for this condition was attributed largely to the managers of our industries.

The second general line of criticism relative to the economic system has to do with the broad question of economic justice. Or, in terms of the above discussion, the criticism is that our economic system falls far short of the ideal of democracy in the ownership of goods and the enjoyment of income. The criticism on this score centers very largely in the question of the inequality of wealth. As indicated in a preceding chapter, the inequality in wealth ownership in the United States is very marked. Inequality in income distribution is much less marked, but still income is highly concentrated. One line of criticism growing out of this fact of inequality is that our economic resources are used to produce luxuries for the rich rather than necessities for the poor. Thus, it is argued that the democratic ideal is being violated. This is closely comparable to the criticism that we are inefficient because goods are made for profit and not for use. If goods were made for the use of the whole people, we are told, the volume of luxuries would be reduced and the amount of necessities would be increased. Thus this criticism questions both the efficiency of the system and the injustice of it.

Criticisms are also made to the effect that inequality in wealth so accentuates the power of the employer in the employer-employee relations that a state of grave injustice comes to prevail. The position of the employee is said to lead to a dwarfing of his personality, because he is made to feel that he is inferior to the employer and to the owners. Furthermore, inequality in wealth permits the employer to pay the employee less than he deserves to be paid. In short, it is charged that under the present system employers consistently exploit their employees.

Another criticism that is offered of our present system is that wealth ownership and economic income may be secured without the rendering of any service. All about us, we are told, men and women receive incomes without rendering service in return for them. Such persons thus take from the social storehouse without contributing anything to it. They are pensioners on the society; they are parasites on the persons who produce the goods

and render the service that make up the living of the world. The fact that such persons pay money for what they receive in no way alters this analysis. If in getting the money, social service is not given that is equivalent to the service received when the money is spent, the spender of it is parasitic. Unearned increments from land ownership and from lucky investments make this possible, it is argued. And also, it is contended that through fraud and corruption of many kinds, and through the production of spurious goods, incomes are secured without the equivalent of genuine service. In general, it is claimed that the system of private property encourages one to get the most possible in return for the least possible. A noted economist offers support for this general charge, by saying: "It is probably not going too far to assert that two-thirds of the durable private bases of income in the United States are nothing less than this capitalization of privilege or of predation." [1]

A third line of criticism that grows out of the inequality in ownership is to the effect that our present society promotes conflict rather than concord. The charge is that the competitive struggle quite necessarily sets brother against brother. The result of this, according to these critics, is that animosities are created, that the finer types of personality are dwarfed, and that only the more wolfish side of men's nature is permitted to develop.

Karl Marx. — One criticism of the competitive system that is of much historic importance, although perhaps not credited by anyone to-day, is the exploitation theory that was developed by Karl Marx. This criticism is part of Marx's central thesis that capitalism will inevitably destroy itself.

Marx is the most important single radical of the present industrial era. His importance warrants a brief biographical account. He was born in Germany in 1818 of Jewish parentage, and died in 1883. As a University student, he proved himself to be unusually capable, and he undoubtedly had a brilliant career before him in any of the learned professions. But he deliberately turned his back upon this and devoted himself

[1] H. J. Davenport, *Economics of Enterprise*, 1913, p. 519.

to a life of bitter attack upon the economic system. He was badly persecuted during his younger days. Driven from his home in Germany he went to Paris, and being expelled from there he went to Brussels. Then during the disturbance created by the revolution of 1848 he went back to Germany, but was again expelled and again went to Paris. He was driven from there again, and then sought an asylum in England, which has perhaps been the safest refuge in the world for the persecuted during the past one hundred and fifty years. In England, Marx developed his system of thought which was published in his book, *Das Kapital*, in 1867.

Marx's central thesis, as already noted, was that capitalism will inevitably destroy itself. In developing this thesis, he first developed his exploitation theory; namely, that under a system of private property an employer necessarily exploits the employee. His argument was based on the labor theory of value which at the time of his writing, in the 1860's, was generally accepted among the economists. This theory was that goods tend to exchange for each other in proportion to their labor cost. Marx extended this in effect to read "All goods and services, including the services of laborers, tend to exchange for each other in proportion to their labor cost." Assume that one cord of wood can be produced in one day and a bushel of wheat in one day, then under competitive conditions one bushel of wheat would exchange for one cord of wood. These two goods would exchange for each other on the basis of the labor time necessary to produce them. If for any reason they did not, if the product of a day's labor in one field would exchange for more than a day's product in the other, the production of the one line of products would be increased and the other decreased until they again came to be equal to each other in exchange. Under competitive conditions in a primitive society of homogeneous labor, it is true that the products of laborers would thus tend to exchange for each other in proportion to their labor cost. This principle is not, however, true in our society, but it is upon it that Marx built his theory of exploitation.

To continue the illustration used above, if a farmer offers to pay a man in wheat for cutting wood for him, how much wheat will he give him for each cord of wood? The exchange, be it noted, is not of wood for wheat, but of labor service for wheat. Since Marx's fundamental proposition is that all things, including labor service, tend to exchange for each other in proportion to their labor cost, the question of the exchange of wheat for labor service will turn on the labor time necessary to produce the wheat and the labor time necessary to produce the labor service. The labor time necessary to produce a day's labor service, according to Marx, is not the time that it takes to render the service but the time required to produce the food, clothing, etc., that the laborer must have in order to work and support his family for one day.

Assume that in one-half day's labor time the laborer can produce enough goods to sustain his life and that of his family for an entire day, then, according to Marx, one-half day's labor time is necessary to produce a day's labor power, or service. Hence, since a day's labor power can be produced in one-half day and a bushel of wheat in a day, one day's labor power will exchange in the market for one-half bushel of wheat. In other words, under the competitive system, says Marx, the laborer would produce one cord of wood in a day, but although the cord of wood is worth one bushel of wheat, he will receive in payment only one-half bushel of wheat. This illustration is typical of the whole process of employment, according to Marx. Laborers are always exploited under a system of private employment, on account of the fact that the laborer sells labor power, and that the labor time necessary to produce labor power for one day is less than one day, or, as Marx assumed one-half day. Thus Marx reached the conclusion that the laborer is necessarily exploited in a system of private property.

This exploitation does not come, according to the Marxian analysis, from any disposition on the part of the capitalist to exploit the laborer, but it arises out of the laws of price. The capitalist is not at fault. It is merely the fact that commodities and labor services are bought and sold by individuals — that

the institution of private property prevails — and the further fact that laborers can produce a day's labor power in less than a full day, that brings about the fact of exploitation.

The exploitation of the employee by the employer gave the employer what Marx chose to call "surplus value." This surplus value obviously became greater, said Marx, as the employer hired more laborers. Thus, as small independent producers were more and more crowded out of business and thrown into the ranks of wage earners, the opportunities were enlarged for the employers to make still greater additions to their ownership, as a result of the surplus value which accrued to them. The result of this was that the rich were gradually becoming richer and the poor poorer. This meant, according to Marx, that the classes of owners and non-owners were becoming more and more sharply opposed to each other. This would take the form of a "class struggle," as Marx called it, between the owners on the one hand and the non-owners or proletarians on the other. Finally, as the process went on the rich would become richer and fewer in number, and eventually the exploited mass of laborers would take over the property of the owners. Capitalism would have become socialism.

It may be said at this place in regard to Marx's system, that his analysis of the inevitability of exploitation is not sound. His basic assumption is invalid. All commodities do not exchange for each other in proportion to their labor cost. The price of land is clearly one exception to Marx's assumption, and likewise the price of a loan of money — the rate of interest — is not related to labor cost. Further, if it were true that the prices of all commodities obeyed this rule, it would still not follow that labor service, or labor power, as Marx called it, would exchange for other commodities in proportion to the labor cost of producing the sustenance necessary to provide labor power. That Marx's principle does not apply to labor is clearly indicated by the wages which prevail. The wages of artists, business executives, and professional men generally show the invalidity of Marx's contention so far as labor services and labor cost are concerned.

Then, too, if we should assume that Marx's proposition is true, at a given time, forces would at once be set in motion which would tend to make it invalid. Thus if we assume that all employers are exploiting their laborers, as Marx argued was always the case, competition among employers for additional laborers would tend to increase the wages of laborers and thus tend to eliminate the surplus value, which according to Marx resulted from the underpayment of laborers. Thus, the conclusion can be safely made that Marx's analysis is not valid.

It should perhaps also be mentioned that Marx's analysis leads him to conclude that employers profit not from using materials and equipment but from the hiring of laborers. According to his theory, employers cannot profit from the use of materials and equipment because these articles and their products exchange according to their labor cost and hence cannot normally be resold at more than the price which the employer has to pay. Hence, Marx concluded that employers profit as they use relatively much labor and little equipment and materials. Thus if Marx's analysis were sound, we should find a business, such as house-painting, far more profitable to employers than the business of making steel, for in the one case the labor item is almost the only element that is involved, whereas in the other case, the cost of the equipment is very large relatively to the bill for wages. Thus the fact that contractors in house-painting do not grow rich rapidly as compared with steel manufacturers indicates the invalidity of Marx's analysis.

It may be that the proposition that many, if not most employers exploit their laborers can be successfully defended. There seems to be no question that this has been the situation in certain lines of industry for relatively long periods of time, but in order to account for this some analysis other than that which Marx used must be employed. A similar point may be made in regard to the validity of Marx's contention that the owners and the workers in the economic system are engaged in a class struggle. There is something to be said for it, but it would be rather difficult successfully to support it as a general proposition. So many workers have become owners that we do not

find a clear-cut division in our system between the owners on the one hand and the proletarians on the other.

In the following chapter, some of the radical programs which have been proposed for remedying the evils of the present system will be considered. The final chapter will discuss the general merits of the present system.

PROBLEMS AND EXERCISES

255. Cite two cases other than those mentioned at the beginning of this chapter, to illustrate the point made in the opening sentence.

256. Give an original illustration to show that prejudice may influence one in reaching a conclusion.

257. Is it necessary that certain assumptions shall be made before a conclusion can be reached regarding whether a given line of conduct is good or bad? Illustrate.

258. On the basis of your experience, do you agree that the two assumptions in regard to what is desirable in an economic society are generally accepted? Illustrate by quoting from conversations you have had or reading you have done.

259. Have the persons whom you have most frequently heard discussing the merits of our economic society been, for the most part, radicals, liberals, or conservatives? Illustrate.

260. (*a*) Give original illustrations of the criticisms which are listed in the text. (*b*) Which of these criticisms do you consider to be the most significant?

261. Prove that goods would exchange for each other in proportion to their labor cost in a primitive society.

262. Develop an original illustration which Marx might have used to prove his point that labor is necessarily exploited under a system of private property.

263. Why, according to Marx, is it impossible for a manufacturer to make a profit on the machinery which he buys and uses in his business?

264. Develop an argument to show the general invalidity of Marx's contention.

CHAPTER LX

RADICAL PROGRAMS

As was indicated in the preceding chapter, the critics of the present society who are known as radicals are not in agreement in regard to the kind of an economic society that we should have. In this chapter some of these programs will be considered. First, it may be noted that the radical is an idealist. The very fact that he wishes to bring about a fundamental change in economic organization testifies to this fact. He is not satisfied with that which he finds, and he sees a vision of a better day. His temperament is that of the poet, his vision is that of the religious zealot, and his courage, in many cases, is that of the martyr, but his plan for the economic organization of society may be very impracticable.

Perhaps a word should be said as to the obvious desirability of considering radicalism fairly. That is really a somewhat difficult thing to do. The impracticability of some radical proposals often leads students to brush them aside contemptuously. But most serious, so far as fair treatment is concerned, is the fear complex of conservatives. This was especially pronounced during and immediately following the World War. Despite our pride as a people in the spirit of freedom, and its corollary, tolerance, we were very intolerant of all persons of radical thought during this period. In 1918 and 1919, for example, Congress refused to seat Victor Berger, a socialist, who was a duly elected representative from Wisconsin, and in 1920, the state legislature of New York suspended five duly elected members because they were socialists. Prominent Europeans were refused permission to enter the country for brief visits, lest their criticism should undermine the economic system.

Teachers in high schools, colleges and universities in most corners of the country were under surveillance to see that they

did not give credence to dangerous doctrine. At this time, the Vice President of the United States, Mr. Coolidge, contributed a series of magazine articles entitled "Enemies of the Republic"[1] in which he discussed the teaching of socialism in women's colleges. The general purport of these articles was that subjects were being discussed and books read in these colleges that might corrupt the thought of the students. In short, instead of the spirit of scientific inquiry, school men of this period were expected to be Jeremiahs, denouncing in hot wrath the critics of our economic society. A saner attitude prevails today, but intolerance rather than reasonableness still prevails in some quarters, but not, we may trust, in class rooms. There the critical attitude of scientific investigation should prevail.

Utopian Socialism. — The history of radical criticism of our economic society is perhaps as old as the society itself, and the criticism of our modern capitalistic system dates from the early days of this system following the beginning of the Industrial Revolution. The economic distress of many of the city workers following the inauguration of the factory system was such as to excite the sympathies of many men. A few severe industrial depressions greatly augmented the distress of the poorer economic groups and still further excited the sympathies of kindly disposed persons.

The factory system was regarded as the evil genii, and proposals were made for escape from this method of production, and from the method of individual competition on which it was based. It was proposed in many quarters that communistic societies should be established, which should be self-containing (independent), and in which liberty, equality, and fraternity should prevail. St. Simon and Fourier, in France, and Robert Owen in England were prominent advocates of such "colonies." These proposed communities were often spoken of as *utopias*, a name suggested by Sir Thomas More's *Utopia*. The word means *nowhere* and was used by More to indicate that the community which he was describing did not exist. The word came

[1] *The Delineator*, June, July and August, 1921, Vol. XCVIII, p. 4, p. 10; Vol. XCIX, p. 10.

to connote an idealistic but impracticable scheme of organization. The advocates of the establishment of such communities were called *utopians*.

The faith of some persons in this general plan of social and economic regeneration was limitless. If once a few such communities were established, they argued, the desirability of such a plan of life would be apparent to all, and communistic societies would become universal. The United States, with its free land, offered sites for such communities and a large number were established during the second, third, and fourth decades of the past century. No one knows how many there were, perhaps one hundred in all. There was considerable difference in the details of organization in the different communities, but they were all communistic. There was no individual ownership, no buying and selling. Some of the groups were strongly religious, but many of them were avowedly non-religious.

One of the most noted of the communities was Brook Farm in Massachusetts. Several of the prominent literary and public men of that period were supporters of this project. Nathaniel Hawthorne, Horace Greeley, and Charles A. Dana were of this number.

Almost all of the communities were dismal failures. The religious ones had a fair measure of success, and a few of them are still in existence. Among these the Amana Society in Iowa, is conspicuous. Its long life and its present state of prosperity justify the faith of its founders. There are about one thousand persons in the society. Life is very simple there. There are no gay clothes and no automobiles. But this is not as a result of poverty but of choice. The work of the community is directed by an elected board, and persons are assigned to the various tasks by this board. All things are owned in common. There is no money in the community for the reason that there is no buying and selling among the members.

But the communistic groups in which the bond of deep religious conviction did not prevail were of short duration. The members in such groups were not sufficiently devoted to the "common good" to make the societies successful. More par-

ticularly they were not strong enough in the faith of communism to resist the principles of individualism which prevailed just outside their gates. The social conventions, especially the economic arrangements, made constant war upon the "queer" communists. Only the most zealous were able to maintain a belief in the new method of economic organization.

Unquestionably, the establishment of such communistic colonies does not offer a solution to the ills of the present system. However ideal life under such organizations would be, if people wanted to live that way, the desire of most people to increase the consumption of goods and the almost universal rule to-day of thinking largely in terms of self-interest robs the question as to the desirability of this method of life of practical importance.

"Scientific" Socialism. — Karl Marx and his followers called the Marxian system of thought "scientific socialism," by way of contrasting it with the utopian socialism which has just been described. But the Marxian system was not concerned with a program of organization. Marx very cannily refused to give details as to the plan of economic organization that he desired to have. To use his words, he refused "to write the kitchen recipes of the future." He was concerned with the downfall of capitalism and the triumph of socialism, considered broadly, but not with the details of the socialistic state concerning the coming of which he was so confident. His references to the future organization were broad and general rather than specific. As a result of this, several divergent schools to-day claim that their proposed programs of organization are truly Marxian. Whether they are or not, need not concern us in this study. The principal point to be made here is that Marx did not devise a program.

State Socialism. — The most generally accepted plan of socialistic organization is what may properly be called *state socialism.* Indeed, the term socialism used without a qualifying adjective is usually taken to mean what is herein called *state socialism.* This form of organization is also often called *collectivism.* The term usually means the common, or state ownership of the "tools of production," or what has been called

industrial equipment in the preceding chapters. It should be noted that the term is not used to designate a situation in which consumption goods are owned by the state. The usual meaning of the term is that consumption goods are to be privately owned and, also, that small scale production goods, such as small shops and small farms, are to be owned privately. The significant point, according to most state socialists, is that the tools of production that are socially significant because of the number of persons employed, should be owned and operated by the state, but that other goods should be privately owned as at present.

As has been frequently emphasized in the preceding pages, we already have some degree of state socialism as illustrated by the state ownership and control of the post office, schools, roadways, and certain municipal utilities; and as noted in an earlier chapter state ownership has been extended much further abroad than it has in the United States. State socialism, then, involves a wide extension of the already prevalent state ownership and direction of economic activity.

It is well to note that state socialists may be divided into two groups — the revolutionists and the evolutionists. The former group was much more conspicuous some years ago than it is to-day. As the term implies, the revolutionists are those who propose a quick and speedy transfer of privately owned industrial equipment to the control and management of the state. The evolutionists are, obviously, those who propose merely a gradual extension of government ownership and operation. Many persons, of course, favor some addition to the body of government owned and operated equipment without wishing the principle to be carried so far that state socialism could be said to result. Some persons who favor the government ownership and control of railways, for example, cannot properly be called state socialists, since there are marked limitations to the degree to which they desire such public ownership and control to be extended.

In regard to the extent of socialistic enterprises, the evolutionary nature of the movement in this direction, and the failure of many people to comprehend the significance of government

enterprises, the following quotation from Sidney Webb, a distinguished English socialist, is often quoted. This was published, it should be observed, in 1889.

"Our unconscious acceptance of this progressive Socialism is a striking testimony to the change which has come over the country of Godwin, Malthus and James Mill. The practical man, oblivious or contemptuous of any theory of the Social Organism or general principles of social organization, has been forced by the necessities of the time, into an ever deepening collectivist channel. Socialism, of course, he still rejects and despises. The Individualist City Councillor will walk along the municipal pavement, lit by municipal gas and cleansed by municipal brooms with municipal water, and seeing by the municipal clock in the municipal market, that he is too early to meet his children coming from the municipal school hard by the county lunatic asylum and municipal hospital, will use the national telegraph system to tell them not to walk through the municipal park, but to come by the municipal tramway, to meet him in the municipal reading room, by the municipal art gallery, museum and library, where he intends to consult some of the national publications in order to prepare his next speech in the municipal townhall, in favor of the nationalization of canals and the increase of the government control over the railway system. 'Socialism, sir,' he will say, 'don't waste the time of a practical man by your fantastic absurdities. Self-help, sir, individual self-help, that's what's made our city what it is.'" [1]

As is implied in the above paragraphs, the usual plan of the state socialist is that the wage system should be continued, as at the present time. That is, it is proposed that the various persons who render service in the state owned industries should be paid wages, as under the system of private ownership which prevails to-day. These wages, as was further implied, could be freely spent for consumption goods according to the wishes of the various individuals. There would, of course, be no opportunity in an extreme form of state socialism for the saving of money and its investment in private business. But under such an organization, it would undoubtedly be possible for individuals to save by loaning their money to the state, on which they would then receive interest. If small scale industry, were permitted as it

[1] *Socialism in England*, American Economic Association, April, 1889, Vol. IV, No. 2, p. 65 (or 135).

doubtless would be, individuals would be free to make investments in such industries either on their own accord or by way of lending to others. Another aspect of state socialism is that under such a scheme the economic system would be directed by public officials. In other words, the various industries that were under government ownership and control would be operated as are the post office, schools, and municipally owned public utilities.

Merits of State Socialism. — (1) *Efficiency.* — The advocates of state socialism see in it a great gain over the present system of private enterprise. Classifying their analysis under the headings of economic efficiency and democracy, which were used in the preceding chapter, their conclusions may be listed as follows: First, so far as economic efficiency is concerned, they insist that there will be much less waste than there is to-day due to the elimination of duplication of effort, such as is found in the case of the delivery of milk and in certain forms of manufacture. With the system coördinated by state officials, they say that there will be no more reason for duplication of effort in the production of iron and steel and shoes, than there is in the conduct of the post office.

Another point under this general heading that is made by the state socialist is that under the proposed scheme there would not be any unemployment. So long as wants were not sufficiently satisfied, there would be no lack of work, they argue. Since under the present system, unemployment results because occasionally private manufacturers cannot produce at a profit, the elimination of the receipt of profits by private individuals would remove the occasion for the industrial mechanism getting out of balance, which now takes place periodically and results in what is called an "industrial depression."

A third point which the socialists make in respect to the economic efficiency of a system of state socialism, as compared with the present capitalistic system, is that necessities would be produced for all before luxuries are produced for any. This would mean, they say, a higher degree of efficiency from the point of view of service to the entire community. A somewhat similar

point is also often made to the effect that under socialism, the quality of goods produced would be superior to the quality which is produced under private industry. Private manufacturers are said to prefer at times the production of shoddy goods in order that they will wear out and need to be replaced. Under government control, energy would need to be directed only to the perfection of goods of superior quality. Both of these last two points are summarized by many socialists in the phrasing that "socialistic production would be for use and not for profit."

We are also told that great savings would result because of the fact that energy would no longer be directed into the channels of advertising and salesmanship, or at least, that the purely competitive aspects of advertising and salesmanship would be eliminated.

(2) *Democracy.* — The state socialists also see great benefit resulting from such a scheme of organization on the score of democracy. There would not, they say, under socialism be a class of idle rich who, to paraphrase a verse of scripture, neither toil nor spin yet live in the splendor of Solomon. Second, it is claimed that then there would be no exploitation of some persons for the benefit of others. Nor, they assert, would it be possible for persons to get income except by the rendering of service. To some extent, such a condition might prevail through the inheritance of consumption goods, or the inheritance of small scale enterprise, or of savings which had been lodged with the state. But clearly there would not be the opportunity for exploitation, or for getting income save as a result of rendering service, to the extent that is possible under the present system.

The Defects of State Socialism. — The critics of state socialism for the most part admit that the claims of the socialists are true to some extent, but they contend that, taken as a whole, the result under state socialism would not be so satisfactory as conditions are to-day. There might not be waste of effort because of the duplication of work, or of plants, and furthermore we might be relieved of industrial depressions and unemployment, but it is argued that the losses as a result of lessened effi-

ciency or other reasons might more than counterbalance the gains in these respects. It seems probable that there would be less economic progress, less venturing in new enterprises, and perhaps less zeal on the part of directing officials than is the situation to-day under the régime of privately owned industries.

The conclusion on this last point, however, is somewhat problematical. It is possible that persons who were in the employ of the government might be as zealous in their activity, and as venturesome in the inauguration of new methods, as is the case to-day. As was indicated in the chapter on government ownership, the result would depend upon the attitude of persons toward their work. This is very largely a matter of social ideals. Individuals respond to the duties laid upon them and to the opportunities before them, as they have been conditioned to respond as a result of the social environment in which they have been placed. The very existence of a high degree of state socialism would normally mean the general social approval of such a method of organization. Hence we should expect that devotion to public duty would be emphasized and that men would strive to excel in this respect. The general success of city schools and state universities supports this conclusion. It may be argued that the persons working in these places are more conscientious than the general run of men. This is, however, very doubtful. In so far as there appears to be a difference, it is perhaps all due to the standards that are held to be desirable in the field of education as compared with other fields of activity. Like standards might well be developed throughout an economic system.

The critics of state socialism argue further that under such a system there would be a far less degree of freedom than prevails with us to-day. This, they claim, would be highly disadvantageous to society. Consumers would be limited in their choice of goods largely to those which are produced by the state, and state production would be controlled by the officials who happened to be in charge. It is reasonable to expect that there would not be the great variety of design in many lines of consumption goods that prevails with us to-day. Thus both as producers and as consumers the freedom of individuals might be considerably

curtailed. To-day through the exercise of their "dollar votes," as we may phrase their spending of money, consumers determine the lines of production with a high degree of freedom. Likewise, venturesome manufacturers produce in anticipation of the sales which they believe that they can make. It would seem that there can be no question that there is a higher degree of freedom in the present system than would prevail under a scheme of state ownership.

Some of the critics of socialism suggest that overpopulation would be encouraged as a result of such a form of organization. The argument is that individuals under such a system would rely upon themselves less than is the case to-day, and that as a result of this there would not be the check upon the birth rate which exists under the scheme of private property. This criticism is perhaps largely invalid. If the socialistic scheme called for the continuation of the wage system and freedom to spend the wages received for consumption goods, there would be the same incentive to check the birth rate as prevails now. Hence the overpopulation argument assumes the principle of communism rather than the prevalence of state socialism.

The argument is also faulty in failing to appreciate that there are many factors other than the economic one operating to check the birth rate. For example, in the purely communistic community at Amana, Iowa, to which reference was made above, the birth rate is relatively low. In 1921, it was 12 per thousand as compared with 20.6 in Iowa as a whole. Since parents have no individual responsibility for the economic welfare of their children, the argument in question would lead us to expect that the birth rate would be very high in Amana. But this is not the case. One element in the situation there is that the religious ideal of celibacy receives considerable emphasis. But however it is accounted for the birth rate is controlled.

Indeed, if under a scheme of socialism, poverty of the masses should be relieved, we should expect that this would result in a reduction of the birth rate. Experience in our system thus far indicates that an improvement in the economic position in any class results in a reduction in the relative number of births. The

same factors would undoubtedly operate under state socialism. Further, if state socialism were generally adopted it might be that along with this there would be a different attitude toward the question of birth control than prevails now. That is, the knowledge of birth control methods might be more widely disseminated under the system of socialism than is true to-day. Legal restrictions are now imposed upon the dissemination of such information.

The question of the state ownership and control of the tools of production in the major lines of industry is, however, of no practical importance. This question is not, and is not likely to become a practical issue. A high degree of state socialism in the United States is almost inconceivable at any time in the near future. Granted that it would be advisable to extend state ownership to include all individual industrial undertakings, there is no probability that this will be done. Private ownership is far too strongly intrenched. Although the ownership of goods is highly concentrated in this country, there is nevertheless a large degree of ownership on the part of small holders. This makes it very improbable that there will be any extensive movement to abolish private property.

The only practical question so far as state socialism is concerned is as to whether some relatively small extensions of government ownership should be made. In short, the above discussion in regard to the merits and defects of state socialism may be aptly characterized as "academic," rather than of "practical" importance. We may, during the coming decades, move in the direction of state socialism, but it is extremely unlikely that we shall move rapidly in that direction.

Syndicalism. — Another theory which is a kind of socialism, using the term broadly, is known as syndicalism. The idea developed in France, and the name is derived from the French word *syndicat* meaning trade union. The fundamental plan of syndicalism is that the principle of trade unionism should be greatly extended — that the workers should become the owners. But the idea is that they should be owners collectively and not individually. Common ownership through the *syndicat* is to be

substituted for the prevailing private ownership. The scheme of the syndicatists means that the present employers will have to seek positions as wage earners. The various syndicats will come to own and control all industry.

Syndicalism may be contrasted with state socialism, the one being a form of collective ownership on the part of the workers directly engaged in the various industries, and the other being common ownership through the political state. The industrial aspect of syndicalism, in contrast to the political side of state socialism, is strongly emphasized by some of the syndicalist writers. They argue that the fruition of the scheme of syndicalism will mean the abolition of the political state. Their argument is that the political state is merely a means by which the present owners and employers suppress the workers. Hence they say that when syndicalism comes to full fruition there will no longer be any need for the political state since then the population will not be divided into economic classes. As part of this general philosophy, the leading syndicalists have advocated the use of direct action in furthering the movement toward syndicalism rather than the use of political action. The most conspicuous element in their program for direct action is the use of the strike. Some writers carry this idea to the conclusion that the transition from the present system of ownership to that of syndicalist ownership and control will be accomplished by means of a general strike by the workers throughout the industrial system.

It may be indicated that the philosophy of the Industrial Workers of the World is syndicalistic. This is a labor organization in the United States which attracted a great deal of attention some years ago, and is still a factor in portions of the western section of the country. The organization, however, has never been sufficiently strong numerically to be of much practical significance.

There is something of the element of syndicalism in the present political organization in Italy and Russia. In each of these countries representation is to a considerable degree based on industrial employment, rather than on geographic location as is

the rule in the United States. Despite the fact that the scheme of syndicalism calls for the elimination of the political state, the basing of political representation on industrial employment has in it an element of syndicalism. It may be noted parenthetically that many persons who are not at all radical in their thinking in regard to economic matters, have advocated political representation on the basis of economic interests.

Further, any scheme of workers' coöperation has in it an element of syndicalism. For example, what is commonly known as producers' coöperation consists of the ownership and direction of an industrial establishment by the workers who are engaged in it. The Columbia Conserve Company of Indianapolis is organized in this way. This organization involves about one hundred persons. A few other industrial establishments have also taken steps to introduce employee ownership and control. Such schemes, to repeat, have in them something of syndicalism.

Most attempts in workers' ownership and control have not been successful. Self-direction on the part of the body of workers has not proven to be as efficient from the point of view of ability to withstand competition as has the usual organization in which the driving power of the "boss," and the fear of losing a job, are conspicuous features. But experiments in such control are desirable, and it is also desirable that workers who are organized in trade unions should experiment in the conduct of industry. It has often been suggested, for example, that the employees of a railroad might save sufficient money to buy out the present owners. The point, too, is often made that in many industries the earnings that are lost by trade unions as a result of strikes would be sufficient, if earned and saved, to permit the union to buy the industry in question. Workers' ownership and control may thus be extended within the present economic system. This bears the same relation to the program of syndicalism that the government ownership of street car lines, for example, bears to state socialism. Each is a step toward the final goal which the writers in the respective fields have set up as the desirable one to attain.

The practical question then in regard to syndicalism has to

do with the desirability of extending producers' coöperation. This is not a political question except when it concerns government owned industries. Shortly following the war, for example, a scheme known as the "Plumb Plan," was proposed for the control and operation of the railroads of the country. This plan contemplated the management of the railway system almost exclusively by the railroad employees. The scheme was thus syndicalistic in nature. As it was proposed to bring this about through congressional action, the question became a political one. But aside from industries that are either owned or controlled by the government, the question of workers' control is one of business management in the particular industries.

Guild Socialism. — What is known as guild socialism is a plan of economic organization that has been proposed by a group of English writers. The scheme in question is a compromise between the extreme forms of state socialism and syndicalism. The essential idea of the scheme is that the various lines of industry within the country should be owned and controlled by the workers therein. These organizations would be known as guilds. The various guilds would then be coördinated through representatives from each guild in what would be known as the Guild Congress. The political state would continue to exist, although all purely industrial questions would be finally determined by the Guild Congress rather than by the political parliament.

The remarks above in regard to the practical question so far as syndicalism is concerned are also applicable in regard to guild socialism; that is, the question of the desirability of an organization such as the guild socialists propose is not a practical issue. The only question of practical importance in respect to this has to do with the extension of ownership and control by workers in particular industries.

Communism. — An interesting experiment in a socialistic form of economic organization is now being carried on in Russia. It was inaugurated in 1917 and thus has been in existence more than a decade. The Russian organization is officially known as the United Socialist Soviet Republics (U. S. S. R.), and is commonly described as communism. The essential idea is syndical-

ism. Emphasis is laid upon control by the workers, who are organized into soviets, and the various soviets are represented in an elaborate system of committees.

Practically, however, workers' control in Russia has thus far amounted to autocratic control by a very small minority of the Russian people. Only members of the communist party are permitted to vote and have a share in control. The present communist party is composed of the persons who preceding the revolution were known as *Bolsheviki*. This word means majority and was used to distinguish the majority group in the communist party, from the Mensheviki, or minority group. Obviously, the Bolshevist group was the effective power in accomplishing the revolution, and has retained control. Membership in the present communist organization is sharply limited. The party comprises only some three hundred thousand persons out of the total Russian population of some one hundred and forty millions. The power exercised by this group is very extensive. The ordinary rights of free speech and free press have been abrogated. There has thus far been an entire absence of democracy. This limited form of control is usually phrased as the *dictatorship of the proletariat.* The analysis of the communists is that such dictatorship is necessary in order to bridge the gap between the system of private capitalism and that of socialism.

There can be no question that the leaders of this movement in Russia have been dominated by what may rather properly be called religious fervor. Their aim has been to bring about the social regeneration of mankind through a new form of economic organization. They are endeavoring to teach the principle of communism to the children in the schools throughout Russia, the aim being to establish the ideal of group service rather than the ideal of private acquisition which so largely prevails in all of the modern capitalistic countries. Children are taught to talk in terms of *ours* rather than in terms of *mine.*

How well the Russian communists will succeed in their endeavor remains to be seen. Following the revolution, an attempt was made to put the principle of communism into practical effect and to abolish all private trading. This was soon

found not to be feasible, and what is known as the *new economic policy* (N. E. P.) was introduced, which permitted private enterprise to be carried on by individuals. Thus Russia to-day is nearer the capitalistic scheme of organization than was true in the period immediately following 1917. It is insisted by some of the Russians that this is merely a temporary compromise with capitalism, and that after the necessary period of education has elapsed private capitalism will be entirely abolished.

The future, it seems, will depend upon the attitude which the Russian people as a whole take toward communism. The great mass of the people are farmers and are individualistic in their thinking. The whole of their life until 1917 conditioned them to this point of view. Whether the teaching of communism in the school and in the press will overcome the established habit of thought is problematical. It will surely temper the old individualism, but it may not be able to indoctrinate the mass of the people with sufficient zeal for communism to permit that plan to triumph.

PROBLEMS AND EXERCISES

265. What was there in the general intellectual atmosphere of the latter part of the eighteenth century and the first part of the nineteenth that contributed to the faith of men in utopian socialism? (Refer to Chapter IV.)

266. Formulate a definition for scientific socialism.

267. Is a state owned railway system or a state university more nearly in line with the principle of state socialism? Discuss.

268. What do you consider to be the greatest merit of state socialism? The greatest disadvantage of this system?

269. Why is it that most attempts of ownership and control by workers have not been successful?

270. Distinguish guild socialism from syndicalism.

CHAPTER LXI

THE PRESENT ECONOMIC SYSTEM

The radical programs that have been discussed in the preceding chapter necessarily raise the question as to the validity of the principle of private property. As indicated in the second preceding chapter, an economist as an economist has no opinion in regard to the fundamental question as to what is good. It may be, for example, that life in small communistic societies, such as Amana, Iowa, may be far nearer the ideal than is life in modern American cities. The economist cannot make a judgment in regard to this matter. As an economist he can form his judgment in regard to what economic arrangements are desirable only on the basis of certain assumptions as to the kind of society that is desirable.

To repeat the discussion in the earlier chapter, the usual assumptions in our society are that it is well to have a large volume of economic goods, and also that a high degree of democracy in our economic relations is advisable. On these assumptions, what can be said in regard to the desirability of private property?

The general answer to the above question is that the system of private property serves admirably. By private property we do not mean a system of unregulated private control of economic goods, but instead a system of private ownership with a relatively large degree of restriction in regard to economic conduct, together with government ownership of certain forms of economic goods. This is, of course, the system that prevails with us today. The defense of the system of private property does not at all mean that private property should not be still further limited through an extension of the principle of social control.

There would seem to be no question that the system of private property thus limited can be roundly defended from the point

of view of the production of a large volume of economic goods. The present system is certainly markedly efficient in this respect. Especially in the United States, the degree of well-being of the entire population undoubtedly exceeds that which the world has known before. It seems reasonable to believe that no system of socialist control during the past one hundred years would have resulted in a similar degree of material welfare.

Freedom versus Control. — The significant element in a system of private property as contrasted with a system of socialism is the freedom of individuals to carry on production largely as they see fit. Human beings tend to be conservative. Social life leads to the formation of rules of conduct which are obeyed rather implicitly by the mass of the people. Some individuals vary from the normal, and question the conventional rules which prevail. These may be called social "sports," to use a biological term. They are radicals, or liberals. But the unimaginative masses do all that they can to repress such individuals and to force their conduct into the normal mold. The masses will not normally tolerate new ideas, new methods, or new processes, whether in politics, economic conduct, or other realms of social life. Social inertia alone offers peace to the man of common mind.

Any form of socialism would strengthen this hold of custom over the affairs of men, because it would give controlling power to the masses. With their votes they could resist change and hold the officials to a high degree of normalcy. They might not choose to do this. They might leave a large degree of discretion to officials, but the chances are that the officials would always keep an ear inclined to the voices of the voters. But with private ownership, bold, imaginative men are to a large degree free to follow new paths. They may produce new goods, institute new methods, and perfect new processes. They will normally encounter some opposition in this, even in a country like ours where we are accustomed to freedom in business enterprise. But still they may go ahead.

This spirit of independence in the conduct of business has unquestionably been of great importance in advancing the eco-

nomic welfare of the people of this nation. It doesn't seem at all possible that any form of socialist control could have led to the degree of experimentation that has been such a marked feature of our economic life. It hardly seems possible that the automobile could have been developed as it has been during the years of this century, if all of the industries of the country had been owned and operated by the government. Some change will inevitably result under any form of organization, but the wider the basis of control numerically, the less tends to be the possibility of change.

The sole proprietor in a business is obviously freer in management than if he had a partner or were a member of a board of directors of a corporation. The advantage of having more money with which to operate a business may offset the loss of freedom which a man incurs when he admits associates, but unquestionably he is less free. The counsel of associates may prevent one from making mistakes, but this may also keep one from attaining brilliant success. There is an old adage, "In a multitude of counsel there is wisdom,"[1] but it is nearer the truth to say, "In a multitude of counsel there is inertia." And socialism means a veritable multitude of counsel.

The economic conduct of individuals must be restricted. Stark individualism would be intolerable. The bold, cunning, and unscrupulous persons would put the masses in bondage. But the forms of restriction should curb the tendencies toward injustice and oppression, and at the same time leave the individual free to experiment in economic affairs. This is the general condition in our society to-day. There are extensive restrictions upon private enterprise, but there is unlimited freedom in the manufacture of new goods and in the perfection of new methods. This is the signal merit of a system of private property.

Another aspect of this is that the exercise of freedom generates enthusiasm and thus leads to the development and expenditure of economic energy that would otherwise not be forthcoming; that is, not only does freedom permit activity to be directed differently from what would otherwise be the case, but

[1] Based on Proverbs 11:14.

it tends to result in the development of a larger fund of economic activity.

The principle of freedom has certain disadvantages. In the first place, the spirit of freedom may lead to such energetic activity that many persons find the pace altogether too fast and become dissatisfied and unhappy under the strain which prevails. It would not follow from this, however, that the condition is not socially advisable. The broader social interest may be served by a degree of activity that seems to many to be very displeasing. This conclusion is especially warranted on the basis of the first of the two assumptions; namely, that a high degree of economic welfare is socially desirable.

Another disadvantage of freedom is that it almost necessarily results that many mistakes are made. Certainly, the greater the degree of experimentation, the greater is the possibility that success will not attend all of the experiments that are made. Our economic system is attended by a rather considerable degree of waste in this particular. A great deal of energy is used in constructing factories that never pay, and in otherwise directing economic activity into channels that do not bear fruit in the form of economic goods. Further, in this connection, the fact of freedom makes possible the duplication of effort in production and in advertising and selling to which reference was made in a preceding chapter. There is also much wasteful duplication of effort in producing goods, and in selling them. And the occasional industrial depressions offer striking evidence of waste. The criticisms of the present system on this score, which were noted in the preceding chapter are valid. But are the advantages of freedom sufficient to outweigh the disadvantages that come from its exercise? An affirmative answer seems to be warranted. The wastes of competition seem to be more than balanced by the gains that result from competitive enterprise. The freedom which prevails in a system of private property tends to promote economic welfare.

This criticism of socialism may easily be pushed too far. While the masses of men are very conservative they may delegate considerable power to officials and leave them to exercise

a free hand. Professor Cooley points out that when the University of Michigan was established, in 1837, to be supported by public funds, considerable fear was expressed lest the farmer-voters of the state would not permit a liberal program to be carried out. But fears were proved to have been unfounded. In almost all of the states, universities have been supported liberally by the taxpayers, and the university authorities have been but little subject to the control of the people. While the officials of the state universities have been somewhat less free than have the privately supported universities in inaugurating new methods and in developing new programs, the restrictions due to the conservatism of the average voter have not been marked. It should also be noted that with the development of large scale industry an increasing portion of the brain-workers are coming to be salaried employees. In such positions they do not have the freedom which they would have if at the head of a one-man business. They are to some degree in the same position as if they were employees of the state. Indeed, as we have more and more large scale enterprise we get nearer to the essential conditions of socialism.

The Assumption That Democracy Is Desirable. — (1) *Inequality.* — The institution of private property is very frequently attacked on the general ground that it tends to prevent the realization of a high degree of democracy in economic relations. Without question this does tend to result, because the institution of private property leads inevitably to inequality in ownership and income. This is, however, not necessarily contrary to the general social interest. As was suggested earlier, there are limitations upon the extent to which the principle of democracy can properly be carried. There is some incompatibility between the two assumptions which have been considered, when they are stated in extreme form. A high degree of economic welfare, as argued above, depends upon the prevalence of the principle of freedom, but this leads to inequality, which is in violation of the principle of democracy.

To consider further the problem of democracy in economic relationships, the point must be made, as noted in an earlier

chapter,[1] that some degree of inequality can be roundly defended as being in the social interest. Any form of social organization that is at all progressive economically — that is striving to produce more economic goods per person — must distribute goods unequally. If there is to be progress, the superior qualities of the superior persons must be utilized. To accomplish this, it would usually, if not always, be necessary to serve the wants of men unequally. The persons who are most effective in the social organization would need to be well cared for, even if persons of lesser importance were allowed to suffer. In an army, for example, it is desirable that the general be well fed even if a whole battalion of soldiers must go on short rations. Thus in any economic system, whether organized under the principle of socialism or private property, some degree of inequality is in the interest of the general social welfare, assuming, of course, that the society wishes to maintain a high degree of economic efficiency.

Under the institution of private property inequality in ownership and income results inevitably from the differences that prevail in the capacities and desires of men. The inequality in buying power that thus comes about leads to the direction of economic activity so as to serve the economic wants of men unequally. Luxuries are produced for the rich before necessities are produced for the poor. In complaining of this, some persons say that the economic energy of the country is thus directed according to the buying power of individuals rather than according to social needs.

But if the argument in the above paragraph is sound, there is not the antithesis between direction according to buying power and direction according to social need, which is implied in this statement. If it was in the social interest that Carnegie should manufacture steel, and if in order to do this it was necessary to permit him to make more money than most men make, and to use some of this money in buying luxuries, then the production of luxuries for him was in accordance with the social need. If the smoking of his habitual cigar contributed to Grant's

[1] Chapter LVII.

generalship of the army, then it was in the interest of the people of the North to produce tobacco for Grant, even at the expense of producing food and clothing for the soldiers.

This principle can easily be pushed too far. Many of the industrial leaders do not demand much, at any rate, in the form of luxurious expenditure as a price for their performance. Most of them are very abstemious in their habits. They live simply in order that they may work effectively. The luxuries that are purchased with their money are largely utilized by their families, and thus only indirectly, if at all, may be considered as a price which is demanded as payment for the economic services of the directors of industry. Further, the inequality that is maintained because of the inheritance of property cannot be generally defended on the score that such inequality is in the interest of efficient performance on the part of able business men. And, also, as noted in an earlier chapter, inequality may become so great that corruption in politics and in business may result. Such a degree of inequality should be prevented if possible.

(2) *Rights and Functions.* — One grave danger in any form of organization is that certain incomes may come to be unrelated to the rendering of service. There have been many instances of this in the past, in the church and in political organizations. Persons who were not performing *functions* have come to claim incomes as *rights*. This is an unfortunate condition. Save in the case of children, or other dependents, *rights* should not accrue except as a result of *functions* performed: the society should not provide economic goods to anyone unless service is rendered in return.

There is danger that a class of economic parasites may be developed in any social organization. A socialist state would not be free from the possibility of this condition, and within the present system of private property a considerable portion of the consumable goods that are produced are utilized by persons who do not render service in return for them. Such persons pay money for the goods they use, but not having earned the money that they spend — not having received it in pay-

ment for service that is beneficial to the society — they are economic parasites, and their death would relieve the working members of the population of a burden that they carry without recompense.

The gains from lucky investments, from ownership of natural resources, from monopoly privileges, from the sales of shoddy goods and spurious securities, and from inheritances and bequests are all largely unearned. In other words, such gains give *rights* without relation to *functions*.

The system of private property is especially likely to lead to the divorcement of rights from functions. The emphasis upon the desirability of having money tends to prevent a close scrutiny of the ethical validity of the means that are to be employed. And the spirit of individualism that prevails under a régime of private property, instead of taking the form of inducing persons to have an abhorrence of being parasites, tends to prompt them to compete with others in a contest to determine who can give the least and get the most. This is a marked disadvantage of a system of private property. The mechanism of the system tends to prevent the realization of the true ends of the system.

Such a result does not necessarily follow from a system of private ownership. It is possible that arrangements may be such that rights and functions will be closely correlated. But to secure and maintain such a condition eternal vigilance is necessary. Emphasis must be laid upon social duties, and legislation must be provided that will restrain anti-social conduct and confiscate unearned incomes. It is only thus that rights and functions can be kept as the counterpart of each other under the institution of private property.

In our society to-day, incomes perhaps largely represent payment for genuine social service. But not all of them are earned; some are stolen and some are found, to refer again to Carver's classification of incomes into earnings, findings, and stealings. The elimination of the stealings and the reduction of the findings is one of the challenges to present-day citizenship.

Production for Profit. — The preceding discussion points to a conclusion in regard to the criticism that in our society pro-

duction is carried on for profit and not for use. These two ends are not necessarily antithetical. The largest profit may be gained through production for use, using the latter term to connote the production of goods of excellent quality. The automobile industry is illustrative of this. The quality of automobiles has been markedly improved during the past decade. This has been the means by which competing companies have sought to increase their profits. Examples can be given of the production of goods of inferior quality in order to enhance profits, but the quality of most goods offered for sale to-day, as compared with the quality of the goods of several years ago; suggests that the profit motive has promoted an improvement in the usable qualities of goods. Certainly, in so far as men are wise in selecting the goods which they purchase they thereby compel producers to attend to the quality of their merchandise.

The Spirit of Conflict. — It is often urged that the institution of private property with its attendant competition promotes conflict rather than concord. Bitterness, hate, and animosities are said to be the natural fruits of such competitive activity. Unquestionably this is true to some extent, but clearly there is a marked compensating advantage in competitive endeavor. Any progressive society — any society that wishes to do better the things that are being done — must invoke the spirit of competition. It is only thus that the persons who are most able to act as leaders can be selected, and it is only thus that the masses of people can normally be stimulated to strenuous endeavor. William James, a noted American philosopher of a generation ago, remarked at one time that rivalry does nine-tenths of the world's work. Perhaps the spirit of rivalry does not account for such a large proportion of the work of the world, but certainly it is very effective in stimulating men to activity, and in addition, as just noted, it is only thus that the social group can select the persons who are best qualified to do the work that it is desired to have done. This is true in all fields of social activity — religion, politics, or economic endeavor.

In a system of private property, competition is the method by which consumers select the persons who are to serve them in the manufacture and sale of automobiles, cement, shoes, and all other economic goods that are produced. And as was implied in the statement in regard to the universal validity of the principle of competition, even in a socialist state, the principle of competition would need to be invoked if the society is to be efficient. It is only thus that men can normally be stimulated to strenuous endeavor, and it is only as a result of trials of strength that the most capable leaders may be selected.

In further consideration of the question as to whether competition is unsavory, it should be noted that all games are based upon the competitive principle. Any inclination on the part of a contestant to relax his endeavor in order to permit his brother contestant to win, spoils any game and is universally condemned. Within the rules that are prescribed to govern fair play, a contestant is normally held in contempt who fails to do his utmost to win.

Another interesting point in regard to the spirit of competition in the field of economic activity is that strenuous activity in business affairs tends to keep the race fit. If men are competing zealously against each other in economic activity, they will wish to keep their bodies sound and their minds clear. Indeed, there is the best of evidence that the intense competitive activity which is characteristic of our present system of private property has been very effective in promoting the bodily vigor of men. If men are to be on the job early in the morning and work effectively during the day, they must keep themselves in good bodily trim. One reason for the decline in the use of liquor is that men cannot use it and compete successfully in modern business.

A society in which the tempo of economic endeavor was less rapid than that which prevails with us might easily lead to some degree of racial decadence. This would be one of the dangers in a system of socialism. Although the competition for position and for social preferment might call for strenuous endeavor and thus contribute to the maintenance of the vigor

of the race, the lack of freedom which would prevail in such a society as compared with the present, would reduce the degree of competition and in so far as that is done, the pressure upon individuals to keep themselves fit for strenuous endeavor would necessarily be weakened.

The general conclusion is, then, that the institution of private property is ethically valid on the assumptions that are generally accepted as to the kind of a society that is desired. But such a system has disadvantages which are a constant challenge to the leaders in the society. The corrective force of social control must be constantly invoked to curb the anti-social individualism that tends to arise in a system of private property.

Social Control. — As has been suggested immediately above and at other places in this book, a defense of the general principle of private property does not imply an acceptance of the principle of anarchism. How to retain the dynamic power of individualism and direct it into lines that are socially beneficial is the major problem confronting modern citizenship. That there will be an increasing degree of social control is inevitable. Indeed, during the entire course of the past century and thus far in this one, the tendency toward an increased degree of social control has been most marked. The principle of *laissez-faire* has become less and less potent during these decades. The fundamental explanation of this, as noted in Chapter IV, is that our economic life is becoming more and more interdependent. This makes rules and regulations increasingly necessary — it makes the unrestrained business conduct of an individual increasingly dangerous to his fellow men.

The increasing degree of social control which appears to be inescapable may take many different forms, chief among which are state ownership and control of key industries, state regulation through boards and commissions, or autonomous control by associations or groups. It is to be expected that there will be some development along each of these lines, but perhaps the two mentioned last contain the greatest possibilities for growth. Both of these cut into the freedom of individual conduct less than does state ownership, and thus they tend to

have a greater degree of vitality than does the method of state ownership.

Government boards, commissions, and bureaus are playing an increased part in our economic life, and there is a constant pressure for more of this control. Not only in the field of the so-called public utilities, but in many phases of agricultural work, factory production, and retail merchandising regulatory boards and commissions have been set up to hold the balance more even than it would otherwise be between the parties that are mutually dependent on each other. And many persons not only expect additional control of this kind, but they invite it. Judge Gary, for example, who was for years until his death, the chairman of the board of directors of the United States Steel Corporation, said before the Stanley Committee of Congress:

> "I believe we must come to enforced publicity and governmental control, even as to prices, and so far as I am concerned, speaking for our company so far as I have the right, I would be very glad if we had some place where we could go, to a responsible governmental authority, and say to them, 'Here are our facts and figures, here is our property, here our cost of production: now you tell us what we have the right to do and what prices we have the right to charge.' I know this is a very extreme view, and I know that the railroads objected to it for a long time; but whether the mere standpoint of making the most money is concerned or not, whether it is the wise thing, I believe it is the necessary thing, and it seems to me corporations have no right to disregard these public questions and these public interests."[1]

The implications of this statement are most far reaching. They are in sharp contrast to the doctrine of unrestrained individualism which has so long received the lip homage of public men. Such an attitude on the part of responsible business men tends to increase the degree of government control, but at the same time it tends to make it somewhat less necessary.

J. M. Keynes points out that the Bank of England is a private corporation, but that it is managed with a view to serving the interests of the British people rather than with a view to increasing the dividends to stockholders. Keynes suggests that

[1] J. H. Williams, "The Sherman Act To-day," *The Atlantic Monthly*, Vol. CXLI, p. 421.

this attitude will perhaps be more and more extended to other business undertakings.[1] The very fact that managers are to an increasing degree salaried officials rather than owners points in this direction. This is one phase of autonomous social control. But it cannot be expected that the social-mindedness of some men will be shared by all men. Political regulations tend to be necessary in order to conserve the social spirit of the few, otherwise they may be forced to follow the methods of their more selfish competitors. But the greater the degree of solicitude for the general welfare the less rigorous need be the government control.

Another phase of control that may be expected to be greatly extended in our economic society is social insurance. The hazards of modern economic life may be considerably mitigated in this way without curtailment of individual freedom. Development along this line will be slow in this country, but it can hardly be avoided. The democratic movement points inescapably in this direction.

What we desire in our economic society may very largely be realized. Its present form was not decreed by God, and written on tablets of stone. It is a living, changing thing. It is amenable to control within the limits of the natural and human resources. If we will we may follow lines of conduct that will still more fully promote the common economic welfare, and hence, we may trust, enrich the entire pattern of life.

PROBLEMS AND EXERCISES

271. Illustrate the tendency of people to accept the ideas of their communities and to refuse to accept new ideas.

272. Cite cases in which the masses have sought to repress men who were advancing new ideas.

273. Does it seem to you that socialism would strengthen the hold of custom? Discuss.

274. "Our school system is conducted on a socialistic basis, yet new experiments are constantly being made." Discuss the validity of this statement, together with its implications.

275. Give an original illustration to prove the desirability of having inequality in income.

[1] *Laissez-faire and Communism*, 1926, Pt. I, Ch. IV.

276. From the discussions which you have heard among business men, and the things which you have read, do you believe that the principal emphasis in our economic society is on rights or on functions? Illustrate.

277. Cite two or three cases of persons whom you have observed who receive economic incomes without rendering any services in exchange for them.

278. Do most of the people whom you know perform a genuine service in the economic society?

279. "The principal problem of citizenship is to make rights correspond with functions." Discuss.

280. "It is impossible for the same man to be given to sensual pleasures, and to love of money, and to be religious. For he who is a lover of pleasure will be a lover of money, and he who loves money, must of necessity be unjust and a violator of the laws of God and man." Plato. Do you agree? Discuss.

281. "As a nail sticketh fast beneath the joinings of the stones, so doth sin stick close between buying and selling." Ecclesiasticus 27:2. Discuss the implications of this statement.

282. "There is thy gold, worse poison to men's souls,
Doing more murthers in this loathsome world
Than these poor compounds that thou mayst not sell.
I sell thee poison, thou hast sold me none."

Romeo, on purchasing poison from the apothecary. *Romeo and Juliet*, Act V, Scene 1. What is the implication of this statement? Discuss.

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